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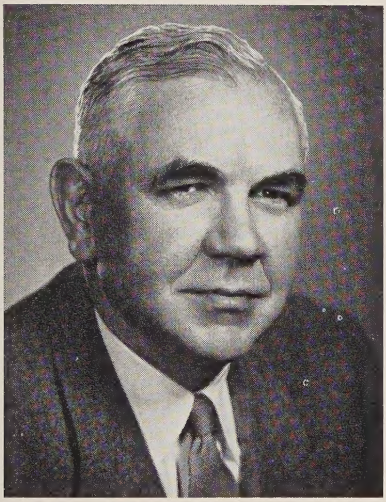
PRESIDENT'S PAGE



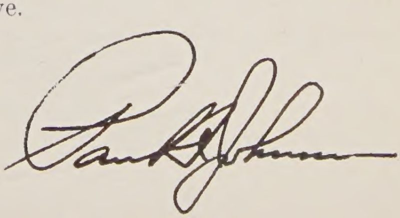
The committee system has been the subject of much humor—and some of it not so far-fetched, as any active Society member can attest. Some of the cause for wit may be removed by good, thoughtful planning—fortunately that's one of the things at which the Society has become increasingly proficient in recent years. Advance, intelligent planning is absolutely essential to any active organization—and particularly to us, with an effective work year of about June to December 1.

Part of the Board of Directors' planning this year was occupied with setting our sights on a small number of over-all goals with which specific activities could be identified, and which would run through the work program for the year. This work program was set forth in "The Organization Plan for 1958-59," an operating manual adopted by the Board for the guidance of committees, officers and directors, and chapters.

The two main goals already announced to the membership are: (1) doing a better job of telling the members about the significant work the society is doing in its committees, chapters, and Board of Directors; and (2) accepting our responsibility to foster strict adherence to high standards of professional work.

The latter goal is not, of course, a new one. It has, however, received special attention and some much needed impetus this year and last. One section of "The Organization Plan" manual has been devoted to "The Society-Wide Educational Program." The program has been outlined in detail, including a plan for its administration by the Committee on Auditing Procedure and Accounting Principles which developed the program last year. Four committees and the chapters are specifically referred to; subject matter has been carefully and chronologically planned. It may easily take us several years to accomplish all that is contemplated, and certainly the job will not be done even then.

A strict adherence to auditing standards, a thorough understanding of accounting principles, and progressive thinking of the expanded services required of CPAs—these are the key-notes of the program, and in fact, of the Society itself. We believe that this exercise of leadership responsibility is one of the Society's most important duties. It cannot help but be one of its most significant services to its members and the public they serve.



Forward Planning for the Accounting Profession

By John L. Carey

The magic word in top management circles today seems to be *planning*. Now that's an old word. It's been in the dictionary and we've used it all our lives, but big business seems to be giving it new meaning and making it almost a term of art.

Business Planning for a Profession?

Mark Eaton, our former president, was very much interested in applying the principles of management to the practice of public accounting, and he made me read a book when he first came into office which I wish every certified public accountant would read. It's published by the Controllership Foundation, written by officers of the General Electric Corporation, and entitled *Planning, Managing and Measuring the Business*.

One of the most striking statements in this book is that the top officers in General Electric, the president and vice-presidents, are instructed in their written guides to spend 75% of their time in *planning*.

I suppose it is only common sense to believe that if we set ourselves clear goals, if we outline in specific terms the objectives we want to attain in given periods of time, and then if we try to think out and put down in writing the steps that we must take to reach these objectives, we'll probably get there with a minimum of effort and wasted time—even assuming that we have to revise our plan in the light of experience. I suppose it's common sense to believe that if we don't have any plan at all, and don't have any clear idea of where we want to go, we many wind up at some later date exactly where we are today—and wonder why.

Now there is one difficulty in applying planning, as business management uses the term, to professional activity. Quite properly we all have the conviction that while business is frankly conducted with profit making as the principal objective, a profession's main objective is service. A professional man by definition is more interested in rendering service than he is in making money. However, that doesn't mean that making money is of no importance at all, and we're beginning to learn that without an adequate income a professional man doesn't have the time or the facilities to give the best work of which he is capable.

I hear such things as this: a certified public accountant practicing on his

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JOHN L. CAREY is Executive Director of the American Institute of Certified Public Accountants. This article is adapted from an address delivered before the Middle Atlantic States Accounting Conference which was held at Myrtle Beach, South Carolina in June, 1958, and it appears here through the courtesy of the Editor of *The Virginia Accountant*.

own account is so busy making out tax returns and keeping periodical audits up to date that he hasn't had time to get into that very important cost system which his client badly needs to increase productivity and profits. This CPA has not had time to think through the situation, to talk to the client, or to train somebody else to do the tax returns, so that he can bring his superior ability and experience to focus on the larger problem, a solution of which will bring higher profits to the client and move the CPA himself forward in his professional growth.

It seems to me that there is no sensible reason why a professional society, a non profit organization such as the American Institute, or many of your state societies, can't apply the basic planning concepts of business management to professional activities. Nor is there any reason why the individual CPA or the accounting firm can't apply these principles without doing any violation to our sense of ethics or our conviction that service is more important than rewards.

Greater Demands for CPA's Services in Sight

Before we can do any planning we need to evaluate our present position. We must know where we are, and how we got here, what the potentials are, and where we want to go.

Well, we all know that professional accounting in this country has evolved somewhat through these stages:

It starts with record keeping and bookkeeping and write-ups. It moves into installation of accounting systems, simple bookkeeping systems, systems of internal control, cost systems, office procedures. It includes financial statements, often prepared by the certified public accountant, although they are legally the representation of the client himself. These statements need auditing for a variety of purposes, sometimes to prevent fraud, sometimes to discharge accountability to stock holders and credit grantors, and sometimes for purposes of the management alone (as in the purchase or the sale of a business).

Early in this century the income tax involved accountants in the preparation of a special kind of financial statement—income tax returns—and brought them to a new function, that of representing their clients before government agencies. And it also brought them into an advisory position, because business men were conscious of the fact that in planning their own investments and transactions they had better be aware of the tax implications.

From these basic services practice has spread into another field, which for the lack of a better name we call management services—these services consisting of a great variety of things that CPAs are sometimes called upon to do, other than record keeping, auditing and income tax work.

Every business, no matter how small, needs all these services to some extent, even though in a very small business the problems may be simple and the level at which it needs this service may not be very high.

We sent out a questionnaire to members last year and found that the bulk of the practice of certified public accountants today is unquestionably auditing, tax work, bookkeeping and write-up work. Other work-management service—is a very small percentage of the whole gross volume of the whole profession, although it seems to be increasing.

Now it's also clear from looking at

a few statistics that the accounting profession has grown, and we take great pride in its growth. However, it may have grown not because of any special merit, but because of economic demands for the kinds of service that CPAs can render. It's evident that we've moved forward with the industrial economy of this country. The accounting profession never developed in an agricultural economy, or a military economy, or a communist dictatorship. It has matured only in industrialized nations, under a democratic form of government and a free-enterprise economic system.

Arthur Foye pointed out in one of his speeches when he was president of the Institute, that the gross national product statistics and the growth of the accounting profession run pretty much on the same curve. In the first quarter of 1957, according to the newspapers, the gross national product was at the rate of four hundred and twenty-seven billion dollars a year; ten years ago it was about two hundred and nineteen billion. It has nearly doubled. Ten years ago the number of certified public accountants in the United States was just about half of what it is now, and the membership of the Institute was much less than what it is now. So if GNP and the number of CPAs continue to follow parallel curves, we ought to look to what the gross national product will be some years from now. The papers on May 21 reported the publication of a Republic Steel Company survey called *The United States of America of Tomorrow*, in which were enlisted the services of two hundred experts from business, government and trade associations, who tried to forecast the economic trend in the years ahead.

By 1965, these two hundred people said, the gross national product will probably be five hundred and sixty billion. That's up a hundred and thirty-three from right now—almost a third. The population will be one hundred and ninety million in 1965 and it's now one hundred and seventy million; so there are twenty million more people coming into the economy. Annual capital outlay of business will be fifty billion, which is compared with, I think, a present outlay of about thirty billion. Reasoning from these forecasts, we can project a very substantial increase in the volume of accounting practice within seven years.

Now there is a wrinkle in this. A lot of people wonder if the increase in volume is coming entirely from the giant corporations, the big companies listed on the stock exchange which are absorbing so many small ones. Will that kind of company flourish while small business withers on the vine?

I was very much cheered to read a speech by Roger Blough, the chairman of the U. S. Steel Coroporation, which was made on March 13 before the Economic Club of Chicago. He cited some figures to support his statement that competition by big business is not preventing the establishment and growth of small businesses. He said that the number of business units, small and large, grows more rapidly than the population grows; and for every company that failed last year, eleven new corporations were established. Now these figures suggest that small business is going to get some substantial share of the tremendous growth of the next seven years.

One more statistic: Dun & Bradstreet estimate that there are now about three million business units in the United States—corporations, part-

nerships, and proprietorships. Now we have some fragmentary data on the number of clients for each CPA and staff man in some of our members' firms, and the number of CPAs and staff men in practice. From these we get a very rough and unreliable estimate that there may be only about fifty thousand CPAs and staff men employed by CPAs, in practice in the country today. Yet it would probably require a hundred and fifty thousand CPAs and staff men, three times that number, to serve three million business units. To put it the other way, there are probably only about a million business units being served by CPAs or CPA firms today, or about one-third of the total.

These statistics are utterly unreliable, as I said, because we haven't had the research facilities to go out and get reliable ones.

But even if they are off twenty or twenty-five percent, they support my point. My point is that there is already an unsatisfied potential demand for your services perhaps as great as the volume of services now being rendered; and in the expanding economy that confronts us in the next seven or eight years, even if no CPA gives service of greater scope or greater depth than he now does, there will be an enormous increase in the potential demand—perhaps as much as one-third.

Greater Scope of Services Expected

But, as a matter of fact, the great increase in the volume of accounting practice in the past ten years, I think, has not come only from the addition of new clients but also from the expansion of the scope of service rendered clients, and the increase in depth of some of the service rendered. This cannot be proved, but from talking to some of you and others in many parts of the country I get the feeling that, while the volume of a given accounting practice may have doubled during the past ten years, as measured by dollars in fees, at least half of that volume is due to increased demands from clients for more extensive and intensive services, and perhaps the other half from new clients.

What I mean by expansion of "scope" is variety of services and numbers of people for whom service is rendered.

Let's take the field of auditing, for example.

There's a bill in congress now—the Fulbright Bill—which would subject unlisted corporations with one thousand stock holders and ten million dollars capital or more to the requirements of the Securities and Exchange Commission, including independent audits. If this should pass, and it's been gathering strength, hundreds more corporations would be required to file with the SEC independently audited statements under the same general type of regulation that now applies to only three thousand or thirty-five hundred listed companies.

The banks have been increasing their demands for audited statements. The vice president of one of the largest New York banks told me at lunch a few weeks ago that the policy of his bank is now "No CPA opinion, no loan." He says this is fairly recent and that they haven't converted all of their customers to it yet. But they have decided as a matter of bank policy that they cannot afford to take the chance of risking their depositors' and stockholders' money without taking all reasonable safeguards that are available to them.

The independent audit by the certified public accountant leading to an opinion is one of these safeguards. This attitude is seeping down, I think, to some of the small banks; and in time it will become pretty widespread.

We have a recently formed committee in the Institute for cooperation with surety companies. Our committee had a meeting with theirs a week or so ago. They told us that the volume of contractors' performance bonds underwritten by their firms is up five hundred percent in the last ten years. They are very conscious of the need for better financial statements from contractors, giving them information on which they can appraise the risk of loss more accurately. We feel that there is an opportunity there for an educational effort that will follow along the lines of our work with the bankers over the last ten or fifteen years, and bring surety companies to the same frame of mind that my banker friend indicated is the policy of his bank.

Perhaps Carman Blough, when he was here, mentioned another area in which a greater demand for audits seems likely. He testified last week before a Senate sub-committee on the legislation that is proposed to regulate employee welfare funds. The bill which Senator Douglas introduced has a provision that employee welfare funds shall be independently audited in accordance with generally accepted auditing standards.

The Labor Department, with whom we have discussed this matter, says that there are two hundred and fifty thousand employee welfare funds in the country having an aggregate of perhaps forty billions of dollars in assets. Obviously, if this legislation should pass, it would immediately add a large volume of auditing work to the existing volume.

I was down in Texas just before I came up here. The Texas legislature has passed three bills this session involving certified public accountants. One permits the insurance companies of Texas to deduct from their state tax the cost of an independent audit by CPAs, which can be accepted by the commissioner in lieu of a state examination. The Texans have passed a new Securities Act, for local corporations, and it contains an audit clause. They've also passed a bill requiring that the financial reports of counties over a certain size shall be audited.

Just before I left New York the Executive Council of the AFL-CIO issued a code of ethical practices for affiliated unions. One provision recommended audits by certified public accountants at least annually.

And so on. By legislation, by custom or by voluntary desire, it looks very much as though every organization seeking credit, looking for capital, or handling other people's money is coming to accept the fact that an independent audit by a certified public accountant is good business.

Let's turn for a minute to the status of tax work, the second big field of CPA service.

There was a time a few years ago when many of us were concerned that the scope of service in the tax field might be limited by some arbitrary legislative or judicial actions. I may be wrong—but I feel that the danger is largely past. I think we may still have some isolated troubles arising from suits for fees for tax work by CPAs, or from local conflicts in which personalities may be involved. But I think that the national leadership of the Bar has learned more about the

place of CPAs in the tax field and has come to accept the fact that this is an area in which both lawyers and CPAs must work. They must work together. I have a feeling that there will be more cooperation between lawyers and CPAs in actual tax practice at the local level than there has been in the past. There will be more referrals to CPAs and more referrals to lawyers by CPAs as time goes on, but no diminution in volume. Perhaps there will even be a greater volume.

In the field of management services, which we haven't yet defined, and which does not yet constitute any tremendous proportion of the total volume, I shall not try to describe specific types of engagements. If you have had time to look at the June *Journal of Accountancy*, you will see our research department's analysis of a survey showing what actual management services a small sample of moderate-size firms have performed, and how frequently. That's a very interesting survey, showing great diversity of types of service over a cross section of practice in about thirty states.

What is of interest to me, and perhaps to you, is the viewpoint or attitude from which this management service can be approached. It seems to me that the best jumping-off place that I've seen lately is a very simple statement by Franc M. Ricciardi, a vice president of the American Management Association: "Unlike the business man of a few decades ago, who was often obliged to make crucial operating decisions on the basis of wholly inadequate data, the present-day executive almost always has available a formidable quantity of facts and figures. His job has taken on a new dimension of complexity. No longer can he afford to rely on hunch or intuition."

I think this is the key to our problem: That management, especially in the larger businesses, has found that decision-making, which is the big job, can't be a matter of just subjective judgment, experience, know-how acquired years ago, or a "feeling for things." If decision-making is competitive, it has to be based on the selection, analysis and evaluation of data. Most of that data is of an accounting nature.

A dramatic illustration of the kind of data that top management uses for planning and decision-making is provided by a fascinating experiment that the American Management Association conducted on May 2d of this year. They got twenty company presidents in New York to play the first "business war game." They based this game on an analysis of the methods of the War College and the Navy College, who for years, as you know, have been training their officers in strategy and tactics by playing what they call "war games." Actually these are simulated combat problems.

The American Management Association applied this principle to executive development. They got twenty company presidents to volunteer, and divided them up into five teams of four men each. They called each team a company, gave them certain data, asked them to make decisions, and ran the results in an IBM 650 electronic computer, which produced a score at each stage of the game. Thus each company knew how it was doing. The object of the game was to attain the greatest improvement in financial position over a ten year period.

The kind of data given to managements included: statements of assets,

an initial operating statement, the number of units of plant capacity, the unit cost of production, the price of the product, the operating inventory, the cash on hand, and the percent of the market controlled by that company. Now all that, except possibly the last factor, is derived from the accounts—it's accounting data. The decisions that they were called on to make involved the next quarter's expenditures for production, for marketing, for research and development, for additional plant investment, and what the price would be for the product.

Of course this was an exercise and didn't prove anything. The only point it has for us, I think, is that it illustrates the kind of thinking that is now becoming common in large and medium size business corporations. And it's the kind of thinking with which small business is going to have to compete if it's going to realize its full capabilities or even survive. I don't know—you know better than I do—but I suspect there are quite a few small business men who don't know their unit costs (if they produce more than one product) or don't have a sound system of inventory control, or don't try in a methodical way to forecast their working capital requirements. They don't keep control of their cash flow, practice budgetary control, or organize estate planning or financial planning in general. It seems to me to be quite obvious that small business, which cannot afford full-time controllers or full-time professional managers who do this kind of thing in the big concerns, can get this kind of help only from you. The certified public accountant is the only person available who can produce this kind of data for small business men and show them how to use it in making their decisions from period to period.

It adds up to the fact that no business is too small to need this kind of service, and that there are about three million small businesses in the country now who need the help of CPAs in the field of management accounting.

How Planning Applies

This line of reasoning brings us back to our main subject of planning. We can accept the fact that by 1965, to say nothing of 1970 or 1980, the *potential* volume of accounting practice is going to multiply itself several times. But even though it is true that the CPA is the only person who can do certain things that business has to have done, it is not necessarily true that all this potential will translate itself into paid engagements. It seems to me that if we want to translate the potential into actual practice, this word *planning* can be extremely helpful to us.

Planning, it seems to us, should be done by each individual accounting firm or by each individual CPA in practice on his own account. Coordinated planning, we feel, should be done by each state society, and above all by us at the Institute. We haven't been too good at it either.

Just for illustration, let's take a plan for a firm or an individual certified public accountant. What's the main objective? Where do we want to be by 1965? Well, you have to frame your ultimate objective in fairly general terms. I've tried to do it, perhaps not very well. However, let's suppose you decide your objective is to do your best to help the free enterprise competitive economy work efficiently and productively in your community. Or let's put it more

simply. You decide that your objective is to do all you can within the limits of your professional ability to help small business compete effectively with large business. Immediately a lot of questions come up. How are you going to do that? If there is going to be a great expansion, where should I be in 1965? Should I be all alone? There's no harm in that, but if I'm alone how am I going to manage my time? Am I going to take every engagement that comes in, or am I going to select engagements and specialize in one field or another or in one industry or another? If I don't think I should be alone, if I feel that I ought to be in a group practice, how many people should I have? What should my target for staff men be? What income will I need to permit me to give the best service of which I'm capable? If I'm just a young fellow who has been in practice for three years, I know I'm not going to advise company presidents on whether to buy a new business any more than a young lawyer, who has been in practice for three years, is going to try a big case before the United States Supreme Court. Nevertheless I've got to evaluate my capabilities and decide how to get the money that will permit me to do the best work I'm capable of doing. In other words, I don't want to spend all my time doing work that can yield only two dollars and a half an hour when I think I'm capable of doing work that's worth ten dollars an hour. How much time should I give to study, and how much time should I give to professional meetings? How much should I give to just sitting back and thinking about my clients' problems, and my own problems, and trying to get some constructive answers to them? How much time should I give to community service and becoming known in the community? What kind of work at what kind of rates will produce the results I want? What kind of work could I delegate to a junior or a secretary or another type of assistant? How am I going to recruit the staff that I think I'm going to need in 1965? Do I go to the colleges, advertise, or go to an employment agency? How have other CPAs done it? After I get them how do I train them? Do I just throw them out on the job and hope they do all right, or do I invest some more time in telling them in specific terms how I want it done? Is there any organization that can help me train them and do it more cheaply than I can do it myself?

And how do I keep in touch with my clients? I'm so busy I hardly have a chance to see them. I sometimes even mail reports instead of taking them over personally and explaining them. How do I know what my client's problem is if I don't see him periodically? How much is it worth to me to find out what he is thinking, and how his problems relate to the service that I can render? And if I don't feel that I can solve his problems because I'm too busy, or because I don't feel that I know quite enough, should I sit on them and just wait until the day comes when I might solve them? Or should I point out to the client that he could get somebody else? Should I suggest another accounting firm or some other specialist to help him? If I do that, won't he appreciate it? And won't that help me grow too?

Basically, planning consists of decisions about the uses of time and the uses of money, which are interrelated, of course. I must decide how much to *invest* in staff development, self-improvement, client relations, library,

mechanical aids and all sorts of things.

Of course, there must be a coordinated plan by the professional societies. We feel that we must have a ten-year plan for the American Institute of Certified Public Accountants; maybe with the help of that plan the state societies can make their own coordinated plans. For example, our objective might be "to bring about full recognition of certified public accountants as a profession of the first rank, with maximum opportunities for service of the highest caliber of which its members are capable." That, of course, is a broad, general objective.

Well, how do we accomplish it? We now have thirty thousand members. Our projections indicate that by 1965 we'll have fifty or sixty thousand members. How are we going to handle those members—the same way we do now, or should we divide up into sections as the Bar has had to do? Should there be a taxation section, a corporate section, a local practice section, a business management section and what-not? Or should there be sections by industry—the oil industry, cattle industry and so on? This is a problem that we have to face.

What should be our relationship with the state societies? Is it satisfactory at the present time or should it be closer? Is the Institute doing some things that the state societies could do more efficiently? If so, are the state societies equipped to take them over? How do we work together so that we are not doing the job twice?

What do we do about the CPA who is not in practice? Our membership is not very appealing to him at the moment. Do we want to bring all of the fifty-six thousand CPAs in the United States into the Institute if we can, or are we mainly interested in getting those who are practicing accounting? Those questions are still unsolved and relate very seriously to our planning.

How much of our revenue should we expect to get from dues, and how much of it should we expect to get from the sales of special services to groups within our membership who particularly desire those services. The Bar Association charges a minimum flat rate of dues that every member pays, and then it charges additional fees or dues to belong to one or more of its sections. The American Management Association does something of the same sort; it charges its members minimum dues, and in addition charges them admission to meetings and for publications. We have that sort of problem too.

Even more difficult is how to allocate the revenues to activities. What's the high priority program? What are our members most interested in first? Should we spend more money in trying to develop a desire to enter the accounting profession on the part of high-school students and college freshmen and sophomores? Should we divert some of the funds going for that purpose to continuing education for CPAs themselves? Many of us have a feeling if the profession is going to take advantage of all of the opportunities that lie before it, we have to set up locally, or at least on a state basis, facilities, such as every other profession has, for CPAs to go back to school again for a week or two weeks, maybe in the summertime, and learn about new development, learn about what other people are doing in the field of management services, for example.

Maybe we should devote more time and effort in the Institute to the subject of the management of the CPA's practice. I think most of you know we are just starting a new project, which you'll hear more about on practice management and the economics of accounting practice.

But what could be more important than the continued development of standards of auditing and compliance with auditing standards and our code of ethical conduct? If these standards are not maintained, the rug can be pulled from beneath our professional status in a very short time. Nothing is more basic than our standards.

Again, we ought to do more research, not only in accounting and taxes, and auditing, but in the field of management services. And we must not forget public relations, because if we do not communicate with groups that have interests in common with us—the business public, the general public, the legislature, and other key people—we may find the whole house collapsing on us.

So we all have a lot of decisions to make. But we don't want to make them without facts, analysis, and logical selection. It seems to me that we have about all the basic ingredients necessary for a recipe of success for the accounting profession. We have confidence in our members. They have integrity—no profession has more—and they have competence. The economy needs them. We have established sound human relations with the business community, and the government, and other "publics." It seems to me that all we need to get the most out of what we've got is this thing that we call "planning."

I think that if we can only put all of these other ingredients together in the right proportions, and do a good job of business management, it won't be long before we have attained the goal of having the CPA universally recognized as "the profession of business."

A Critical Look at Generally Accepted Auditing Standards

By R. K. Mautz

In 1947, the Committee on Auditing Procedure of the American Institute of Accountants published a *Tentative Statement of Auditing Standards* [1] in which nine propositions were offered, three as general standards and three each as standards of field work and reporting. A summary statement of these standards was approved and adopted by the membership at the annual meeting of the Institute in September, 1948. At the Institute's annual meeting in November, 1949, the membership approved a proposal concerned with the expression of an opinion by independent certified public accountants on examinations restricted in scope or requiring substantial qualifications for other reasons. The essence of this proposition found its way into publication as an auditing standard in 1954 when the original nine tentative standards plus this additional standard of reporting, ten in all, were again published, this time as generally accepted auditing standards.[2]

[1] *Tentative Statement of Auditing Standards*, American Institute of Accountants, New York, 1947.

[2] *Generally Accepted Auditing Standards*, American Institute of Accountants, New York, 1954.

It appears that the first two words of this description, "generally accepted auditing standards," were well chosen. Although a considerable number of articles appeared in professional periodicals prior to 1947, some of them critical of the possibility of and need for a statement of auditing standards, little of a critical nature has appeared since the publication of the tentative standards in that year. Except for the addition of the one standard mentioned, the tentative standards proposed in 1947 were accepted without change and apparently with little or no criticism. It is the purpose of this paper to subject the ten generally accepted auditing standards to the critical study which they have long merited but have not as yet received. In defense of this critical approach, I hasten to add that it is intended to be constructive. It is hoped that out of such an examination may come a stronger, more useful statement of auditing standards.

It may be well to put the present standards in perspective by briefly reviewing their history. How did they come to be? What was their pur-

R. K. MAUTZ is Professor of Accountancy at the University of Illinois. This article is adapted from a paper which was presented at the Twentieth Annual Institute on Accounting which was held at The Ohio State University, Columbus, Ohio in May, 1958.

pose? How well do they fill the need they were developed to meet?

The first published reference to auditing standards apparently is found in S.E.C. Accounting Series Release No. 21 which appeared in February, 1941. This release was aimed at improving the form and content of accountants' certificates and required that:

> "The accountants' certificate . . . shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; . . . ."[3]

Previous to this, the guide to an adequate audit was found in the pamphlet, *Examination of Financial Statements by Independent Public Accountants*[4] published in 1936 by the American Institute of Accountants. This pamphlet is the direct descendent of a proposal by the Federal Reserve Board in 1917 recommending procedures to be followed in the preparation and audit of the financial statements of manufacturing and merchandising concerns. Entitled "Uniform Accounts," this proposal first appeared in the April, 1917 issue of the *Federal Reserve Bulletin*.[5] It was issued by the Government Printing Office in pamphlet form in the same year[6] and reissued in 1918 under the more descriptive title, *Approved Methods for the Preparation of Balance Sheet Statements*.[7] In May, 1929 a revised version prepared by the American Institute of Accountants and entitled, *Verification of Financial Statements* was published by the Government Printing Office.[8] From 1932 through 1934, the American Institute of Accountants and the New York Stock Exchange carried on a substantial correspondence concerned with this subject[9] and finally in 1936, *Examination of Financial Statements by Independent Public Accountants*, a revision of the 1929 pamphlet, was published by the American Institute of Accountants.

As one result of its investigation in the McKesson-Robbins Case, the S.E.C. indicated its dissatisfaction with auditors' opinions which made no mention of this publication, yet which accepted it as authoritative in establishing their responsibilities. Release No. 21 reads in part:

> ". . . it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate."[10]

The year 1941 thus provides not only the first authoritative use of the term "generally accepted auditing standards," it also marks the point at which fairly detailed rules and procedures for financial statement ex-

[3] United States Securities and Exchange Commission, *Accounting Series Releases*, p. 38, United States Government Printing Office, Washington, 1956.

[4] *Examination of Financial Statements by Independent Public Accountants*, American Institute of Accountants, New York, 1936.

[5] "Uniform Accounts," *Federal Reserve Bulletin*, April 1, 1917, p. 70.

[6] *Uniform Accounting, A Tentative Proposal Submitted by the Federal Reserve Board, Washington, for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants*, Government Printing Office, Washington, 1917.

[7] *Approved Methods for the Preparation of Balance Sheet Statements, A Tentative Proposal Submitted by the Federal Reserve Board, Washington, for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants*, Government Printing Office, Washington, 1917.

[8] *Verification of Financial Statements*, United States Government Printing Office, Washington, 1929.

[9] *Audits of Corporate Accounts, Correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934.*

[10] *Accounting Series Releases*, p. 37.

amination and preparation were supplanted by less specific auditing standards. From 1941 until 1947, when the tentative standards were first published, a considerable expenditure of time and effort was directed at the development of auditing standards and a form of accountant's report that would refer to such standards satisfactorily.

With considerable accuracy, therefore, it can be said that our generally accepted auditing standards appeared as the direct result of pressure by the S.E.C. for improvement in the form and content of accountants' short form reports. But accurate as this claim may be, it is little more than a half truth. It can be contended with equal validity that, by the late 1930's, public accountants as a group were becoming aware of the professional nature and stature of their work to an extent never before so generally felt. As happens at some point in the development of every profession, not just a few leaders, but a considerable number of practitioners began to comprehend and appreciate the social importance of public accounting and of professional responsibilities. The responses in 1937 to the American Institute of Accountants' fiftieth anniversary essay contest on the subject, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards" and the Sanders, Hatfield, and Moore monograph, *A Statement of Accounting Principles* [11] are indications of this. The profession was ripe for such efforts as the development of professional standards; the McKesson-Robbins Case and the S.E.C. may have forced the issue a few years earlier than would otherwise have been the case, but the pressure was certainly mounting. The explosion of interest in principles, standards, and professional responsibilities which even the second world war could not stem was inevitable and would not have delayed much longer even without the timely urging of the S.E.C.

Therefore, the purpose of the auditing standards developed by the Committee on Auditing Procedure cannot be described as merely to meet the pressure exerted by the Securities and Exchange Commission. This was perhaps the immediate incentive, but the real purpose must be viewed as something far more fundamental and long-range in outlook. This more basic purpose might be expressed in a variety of ways, but stated simply it was to raise the level of professional performance. If we look closely at the nature and purpose of standards, it becomes apparent that such must be their real function. As defined by C. A. Moyer, "Audit standards are criteria or measures of performance which are established by authority or general consent as general guides to action. They imply a degree of uniformity in quality of performance." [12] Standards give to all concerned an indication of what is required if a given examination is to be considered adequate in scope and performance, and by so doing help to raise the general level of professional practice.

This basic purpose of auditing standards can be made more specific by considering the needs of the different groups concerned with professional performance. Standards should provide guides:

1. For the evaluation of profes-

[11] Sanders, T. H., Hatfield, H. R., and Moore, U., *A Statement of Accounting Principles*, American Institute of Accountants, 1938.

[12] Moyer, C. A., "Audit Programs and Standards, Principles, and Procedures," *The Journal of Accountancy*, December, 1952, p. 687.

sional performance by practicing public accountants.

2. To indicate accepted requirements of practice to those outside the profession who have occasion to judge or evaluate the work of practicing accountants.

3. To suggest the extent and nature of education expected of those preparing for entry into the profession.

Thus generally accepted auditing standards, if they adequately fulfill their function, provide the practicing accountant with a basis for self-review, a means of evaluating his own work so that he may determine whether or not he is satisfying his professional responsibilities. They should give courts, commissions, and other interested parties a reasonably clear indication of what professional accountants hold as required in the adequate performance of an examination of financial statements. Finally, they should be useful to teachers and students for educational purposes. From the standards it should be possible to determine what a student should know and understand in order to be considered sufficiently well trained to be useful on professional assignments.

A frank evaluation of the ten generally accepted auditing standards finds them generally unsatisfactory for these purposes. Their issuance met the demands of the S.E.C. and satisfactorily fulfilled the immediate need; it is extremely doubtful, however, if they have been effective in raising the level of professional performance in any substantial degree.

This rather harsh assertion cannot be proved empirically, but a hard look at some of the standards themselves leaves one with little room for disagreement with this unhappy conclusion. Take, for example, any one of the general standards. The first one reads:

> "The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor."

If one seriously tries to take the point of view of an outsider, he is likely to read this standard as saying that an auditor ought to have enough training and experience to know what he is doing. This seems so obvious a requirement as scarcely to justify repetition. But how much technical education is required? How does one measure the required proficiency? Just what are the standards by which these desirable characteristics are judged? How can one tell if a given auditor does or does not have adequate technical training and proficiency? No help is given on these pertinent matters.

Standards (2) and (3) in this group are no more helpful. They read:

> "2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
>
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report."

In short, an auditor must be independent; he must exercise due care in his work. But how does a young practitioner judge his own extent of independence? When has he overstepped the bounds and lost this essential characteristic? Can we give him no help here at all? And isn't "due care" another obvious requirement, so obvious, in fact, that failure to specify what it means robs this standard of any real significance?

This type of question can be directed at the standards of field work with equal validity.

> "Standards of Field Work
>
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
>
> 2. There is to be a proper study and evaluation of the existing internal control as the basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
>
> 3. Sufficient, competent, evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."

Does any one of these really add to an inquiring reader's knowledge of what is required in an audit examination? Is a judge, a member of a jury, an accounting student, or even a practicing accountant substantially more able to judge professional performance after reading these standards than before? The use of such qualifying terms as "adequately," "properly," "sufficient," and "reasonable" in propositions as general as these comes close to relieving them of all effectiveness. Do these statements give any real guide to a beginning practitioner with respect to the extent of his internal control review or the kinds of evidence he can rely on? And if they don't do these things, are they fufilling their purpose? Can they raise the level of professional performance?

The standards of reporting, for some reason, are of a substantially different character. These are much more specific than those relating to performance of the examination. The first one reads:

> "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting."

Although we have never satisfactorily stated the "generally accepted principles of accounting," this standard is clear and to the point. A specific statement on a specific subject is required in the audit report. Without it, the report fails to meet the standard. In effect, this is a rule. The third standard in this group is much like those given in the other two groups, so unspecific as to be of little help:

> "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Numbers (2) and (4), like number (1), are sufficiently specific to have meaning.

> "2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
>
> 4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

In short, our ten standards divide themselves into two groups. Three of them, all related to reporting, not only are fairly specific, but are in the nature of rules; the other seven are so general and include so many qualifying terms as to be of little informative value to anyone. It is on this fact that one can challenge their usefulness as standards. How can such indefinite statements serve as guides to anyone? How can such belaboring of the obvious raise the level of professional performance?

Although the question of why we have such indefinite standards appears to have little to do with improving the situation, it is still an

intriguing one, and an answer may help us avoid a similar error again. One very likely reason is that we have a confusion of principles and standards. *Generally Accepted Auditing Standards* points out that in discussions with the Institute Committee, the Commission stated:

> "Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures . . ."[13]

This unfortunate confusion of terms may have led to the selection of these broad, general statements not at all suitable as standards. Another reason for the development of standards in the form that we now have them could be a desire to avoid the specific type of instruction found in *Examination of Financial Statements*, previously the "standard" for evaluation of auditing performance.

Of course, these are surmises at best, and the more important task is to consider the standards themselves. What, if anything, should be done with them? Should they be abandoned, revised, modified, or left as they are?

Here I must be careful to make my position clear. I feel that we have a real need for auditing standards. For the reasons stated earlier, to raise the level of professional performance, to guide practitioners, students of accounting, and those who must judge the efforts of practicing auditors, we need good standards. The fault of our present standards is not that they exist; it is that they do not go far enough in fulfilling their purpose. They fall short of providing the guides that are urgently needed. Rather than abandoing our present standards, I urge they be supplemented and expanded. They tend to mark out the general areas in which guidance is needed; let us now develop more useful guides within these areas. Let us develop, for example, supplementary standards indicating the nature of competent evidential matter, and, if possible, guides for evaluation of the sufficiency of evidence in specific cases. Let us indicate what is comprehended in a proper study and evaluation of internal control. Let us indicate more specifically the characteristics of independence, in order that its presence or absence may be judged. Except for the standards of reporting already noted, it seems entirely possible that supplementary standards can be developed to support and expand each of the present standards.

Some may fear such a proposal as this on the grounds that it will result in rules and regulations that will regiment the profession and hamper the exercise of essential judgment. This is an eventuality that could occur, of course, but there is no reason why it must. The line between too little and too much restriction is a fine one, but it is the task of standards to seek this out and mark it as clearly as possible. The present standards themselves are restrictive; they require that certain conditions be met. Any effort to raise professional standards must be restrictive, but this in itself does not eliminate judgment. For example, the decision of *whether* to review internal control has been eliminated by the present standards; an appropriate review is required. The much more difficult question of *how* to review internal control in each of many examinations still exists, and its solution calls for the skillful exercise of judgment in each case. Similarly, due care is required, but

[13] *Generally Accepted Auditing Standards*, p. 12.

choice of methods of exercising it is left to the auditor. Thus standards curtail judgment in one area but avoid infringement on this professional characteristic in others.

Expansion of the standards as recommended here should be almost completely in the direction of limiting judgments with respect to whether or not a given step should be taken; seldom should standards infringe in any way on the exercise of judgment concerned with how to proceed with performance of the required step. Restriction of the "whether" type of judgment is required if the level of performance of the profession is to be raised; freedom of choice with respect to the "how to do it" type of decision is essential to maintenance of the professional stature of accountants. Any attempt to develop supplementary standards should recognize these fundamental limitations.

What we need is considerable study of our present standards. To what extent do they provide the guides we need; in what respects do they fall short? How can they be expanded or supplemented so that they may become effective standards to measure, evaluate, or teach professional performance? How can these supplementary standards be worded so that they offer guidance to a practitioner or a student without unduly limiting judgment and freedom?

As an illustration of what is intended by supplementary standards, let us direct our attention to the third general standard. "Due professional care is to be exercised in the performance of the examination and the preparation of the report." As suggested previously, this standard offers little real guidance. Can we indicate the nature and meaning of due care in audit work any more definitely than this? Can this standard be supplemented by one or more statements indicating specific points at which care is required and the nature of the steps to be taken in the exercise of professional care? Certainly the members of the committee responsible for this standard had something more in mind than a vague thought that one should be careful in the performance of professional work. Unless we are seriously incapable of expression we should be able to state these thoughts as guides for those who perform such work.

It seems likely that the members of the committee had in mind such essentials as the need for alertness at all times while performing audit tests, the importance of recognizing interrelationships among accounts and accounting data, the fixing of responsibility for work completed, the amount and extent of review reasonably required to reduce the possibility of error on the part of the audit staff and similar matters. Stated in the form of supplementary standards these might appear somewhat as follows:

1. Alertness to the possibilities of errors and irregularities and to the implications of inter-relationships in the data under review is required of all members of the audit staff at all times.

2. Acceptance of responsibility for work performed, and indication of such acceptance, is required of all members of the audit staff.

3. A review of the audit program should be made by a competent and responsible person subsequent to and based on study of the internal control in effect and prior to completion of the field work.

4. A review of the work papers and audit work of each man should be made by a competent and responsible person before the completion of the field work.

5. An evaluation of the significance of every error and irregularity discovered during the course of the examination should be made by a competent and re-

sponsible person. Every material error and discrepancy, including any implication of other errors and irregularities, should be investigated completely.

6. Particularly difficult or unusual problems arising during the examination should be referred to a qualified specialist, or at least discussed with competent and responsible persons.

7. The audit report should be reviewed by a competent and responsible person and consideration given to the adequacy of the work paper support before the report is released.

8. Provision should be made for report checking and proof-reading as necessary to give reasonable assurance that clerical and typographical errors in the finished report have been eliminated or reduced to a minimum.

Most of us would agree that failure on any one or more of these points would indicate lack of due professional care. These requirements carry us beyond the basic standard and help us to get at the meaning of due professional care "in the performance of the examination and the preparation of the report." They indicate the points at which care should be directed; they do not specify how the care is to be implemented; thus they fall within the proper boundaries of professional standards.

Some may challenge these statements on the ground that they are as general and indefinite as the basic standard; others may contend that they are overly restrictive. I think that neither of these charges is completely justified. By specifying points of attention and general methods of approach, they add much to the clarity of the original standard. By refraining from detailing the procedure to be followed, they avoid undue restrictiveness. I think these or similar propositions could help in raising the level of professional performance by giving desirable guidance to practitioners, students, and others.

It should be clearly understood that these are not, as they stand, submitted as supplementary standards. They would require a great deal of intensive consideration and probably modification or revision before they would warrant such a claim. They are offered here merely as an indication of how supplementary standards might be developed. The ones suggested here may be too few or too many, too general or too restrictive. They do, however, indicate the general nature of supplementary standards and the purpose which supplementary standards could well serve, once developed and accepted.

Are such supplementary standards really needed or are they something we can get along without for a good many more years, just as we have in the past? A realistic answer to this requires a little soul-searching and self-criticism by the profession. It can be contended that accounting tends to delay until it is actually in difficulty or at least under pressure before ever seeking any remedy. The profession was ready for the development of auditing standards, true, but nevertheless it did wait until urged by the S.E.C. before making any real progress. The impetus for development of *Examination of Financial Statements*, a publication of unquestioned benefit to the profession, came originally from the Federal Reserve Board. To a greater extent than we like to believe, the story of progress in accounting is a record of important cases in which accountants appeared in an unfavorable light. Mr. Saul Levy has pointed out the possibility of having standards for the review of internal control forced upon us by a jury of laymen if we neglect the de-

velopment of such standards ourselves.[14] Certainly this may be possible in other areas as well. Indeed, a question may be raised as to whether we can claim true professional standing if we do not have realistic standards for the evaluation, improvement, and policing of our professional work. It seems to me that the need for such standards and the obvious dangers in foregoing their prompt development are such that we should lose no time in commencing what may be a long and arduous task.

How are such standards, if they are desirable, to be developed? The first thought, of course, is that a committee, either one now in existence or one formed for the purpose, be assigned the task. But in my opinion, this approach does not offer the greatest promise of success. We are not yet ready for committee activity in this area. First, we need a great deal of preliminary and exploratory work, a great many interested members of the profession, working alone or in small groups, attempting to express as clearly and as concisely as possible their interpretations of the ten generally accepted auditing standards. Committees, by nature, can do little more than consolidate progress; the initial gains in a field such as ours come primarily through the research efforts of individuals or small groups. Not until this subject has been intensively studied by a goodly number of keen minds and the results of such studies made available for discussion and criticism will we have reached the committee stage in the development of supplementary standards.

Now what does this all add up to? First, I think the present ten generally accepted auditing standards are not adequate for their purpose. They tend to be either rules on specific reporting practices or such general, indefinite requirements as to be of little benefit in raising the level of professional performance. Second, there is real danger in maintaining to ourselves and to the world that these pleasant generalities are the only professional standards we need. Public accounting has an unfortunate history of moving only when it is moved upon. Imposition of standards by outside pressure of whatever kind is surely less desirable than developing and establishing our own. Third, the present generally accepted standards can serve as a basis for the development of a series of supplementary standards to provide more specific guidance than is now available. Such supplementary standards need not interfere in the least with the exercise of appropriate professional judgment, and they are fundamental to any serious effort to raise the level of professional performance. Every member of the profession, particularly if he is in full time practice, has an opportunity to make a real contribution to this development through analyzing carefully his understanding of the present standards, offering suggestions for their modification and working in every way possible toward their clarification and expansion. I think this is as important a task as faces the profession. We would do well to get on with it.

[14] Levy, Saul, "Internal Control and Legal Responsibility," *The Journal of Accountancy*, Februray, 1957., p. 31.

THE DETERMINATION OF NET INCOME

By Ira N. Frisbee

In the United States the number of investors in large businesses has been increasing rapidly. The number of stockholders in General Motors Corporation, for example, increased 27 per cent between January 1, 1955 and June, 1956 to a total of 621,000. General Electric Company had a 22 per cent increase in the average number of stockholders in 1955 as compared with 1954.

These numerical increases in stockholders do not give the complete picture. The number who *indirectly* are the owners of the capital stock has been increasing also. Pension funds and profit-sharing funds have been established by many corporate employers. Health and welfare funds are now common in the labor unions and pension funds have been introduced in these organizations. Some of these savings are invested in the capital stocks of American corporations. Thus, we find that the number of people who have reason to be interested in the results of such investments is much larger than the number of stockholders. A large part of these investments is made for the primary purpose of accumulating wealth to provide future income, rather than current income for the participants.

Accompanying the increases in stockholders there has been more extensive and more frequent financial reporting by the corporate officers, particularly as to profits. A considerable number issue quarterly statements of income in addition to the annual audited financial statements dealing more extensively with the operations of the year. These frequent reports recognize that the chief interest of the stockholder is in the earnings of the business. How much is the profit per share this year or this quarter or this month? How much was it last year? How much can be expected next year? And how much will be paid in dividends?

Nevertheless, business profit is a term which is quite indefinite and nebulous. Certainly for the intermediate periods in the life of a business it cannot be determined with exactness. A carefully worded annual statement of income might be called a "tentative statement of profit." Only a statement covering the entire life of a business can be deemed to be accurate in the determination of profit.

Economic Income and Financial Reporting

Such a statement, although accurate in the monetary units in which it

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is presented, is not likely to be accurate from the standpoint of economic income because of changes in economic value of those monetary units. For example, if a person invests $100,000 in a business and ten years later, upon winding up of the business and without any previous withdrawals, receives exactly $100,000 as his entire recovery, we may say accurately that he has had no monetary profit or loss. But if the value of those dollars has changed in the ten years so that they will buy only one-half of what they would purchase at the beginning of the period, it is obvious that there has been an economic loss of 50,000 of his original dollars, or one-half of his investment. We cannot deny the occurrence of such a loss even though the only factor affecting the value of his original $100,000 was the changing price level. In fact, in terms of current dollars, his loss is not $50,000 but $100,000. Instead of having 200,000 current dollars from his $100,000 investment of ten years ago, he has only 100,000 current dollars.

Even if the investor were to receive $200,000 in return for his $100,000 investment under the circumstances just described, would he have any satisfaction in recovering the same purchasing power that he originally invested if he has had no spendable income during the period of his investment? Certainly the receipt of $200,000 in this case would not result in any spendable income. All the investor could say is that his capital was not dissipated. Is this not something he should know during the ten-year period when operating results are being reported to him in each interim period? If dividends had been paid to him during the ten-year period as a result of accounting methods which failed to recognize the decrea- ing value of the dollars, the stoc- holder would think that he was r- ceiving spendable income whereas h- might only be receiving part of h- original investment.

Profit and the Conservation of Capital

Economic profit also should be re- ognized as important to the corpora- officials who are responsible for th- management of business enterprise. It is the duty of management exec- tives to protect the investment of th- stockholders. This requires a mea- urement of the effect of price i- creases upon the capital requiremen- of the enterprise. A comprehensi- picture of the financial status of business and of its future capital r- quirements is not necessarily obtain- by stating assets on the basis of hi- torical cost. If a portion of the asse- are stated at 1939 dollars where- other assets are at 1946 dollars a- still others are quoted in a mixture 1956 and 1957 dollars, the resulti- measurement of the capital requir- ments may be quite misleading. If, ascertaining profit, the expenses a- determined by recording either th- sale or use of assets in terms of ou- of-date dollars, the resulting "n- profit" may not be available to th- investors. It may be partly or e- tirely needed to replace the asse- sold or consumed. In other words, may be capital required to contin- the business—that is, to continue t- same volume of operations witho- expansion of plant or of inventorie- To the extent that such a moneta- profit is required to continue oper- tions which are identical with t- past operations, it is difficult to fin- any basis for labelling it as "profit- However, to measure the extent

he misnomer or to avoid its creation n the accounts requires continuing adjustments within or without the ooks of account.

European Practices in Recording Replacement Values

At the Sixth International Congress on Accounting in 1952 eight papers were presented on the subject "Fluctuating Price Levels in Relation to Accounts." Within the limits of the present discussion it is not possible to review all of the excellent presentations or to summarize all of the points of view expressed. Nearly all of the speakers were in favor of eliminating at least part of the effects of fluctuating price levels in the ascertainment of profits. The methods of accomplishment differed. Some favored an adjustment only in the historical cost of fixed assets and of depreciation to be made at periodic intervals when an appreciable change in value had occurred. Apparently the revaluation dates would be infrequent. At those dates the plant assets would be valued at current prices and for a time thereafter, until inflation became marked, the resulting expression of depreciation would not differ materially from the current level of prices. This point of view has been followed in England. For example, the financial statements of the Imperial Chemical Industries, Limited, show that a revaluation of physical assets took place as of January 1, 1950, with the allowance for depreciation determined on the revaluation basis.

Other participants at the Sixth International Congress supported the thesis that replacement values should be recorded annually upon the books and in the financial statements in order to state correctly the profits of the enterprise and the amount of capital employed. It is interesting to note that the replacement-value theory is being used by important companies in the Netherlands. The annual reports of N. V. Phillips' Gloeilampenfabrieken present the property, plant, and equipment on the basis of replacement value less depreciation, and the inventories also are shown at replacement value. These replacement values are determined by means of indexes measuring the price trends of the various assets. An account called "revaluation surplus" is credited or charged with the changes in the replacement values. Profits are ascertained by calculating depreciation expense on the replacement values of the property, plant, and equipment, and by using replacement values for raw materials and other elements of the cost of sales.

Replacement values instead of historical costs are similarly used by the Algemene Kunstzijde Unie N. V., a Netherlands corporation, as stated in a prospectus issued in the United States in 1953 in connection with its offering of American shares. This prospectus stated that the net income "has been determined on the basis of generally acceptable accounting principles in the Netherlands, which principles include, in the determination of net income, provision for depreciation on the basis of estimated replacement value rather than historical cost . . . and costing of sales at replacement value rather than cost. . ."

Adjusted Historical Cost

One speaker at the Sixth Congress, Professor Willard J. Graham of the American Accounting Association, presented "adjusted historical cost" as the preferred basis for the periodic reporting of income and compared this method with replacement cost.

His paper embodies the recommendations of the American Accounting Association Committee on Concepts and Standards Underlying Corporate Financial Statements presented in their "Supplementary Statement No. 2" which was issued August 1, 1951, and is published in the *Accounting Review* for October, 1951.

Adjusted historical cost is stated to be "historical dollar cost adjusted to a current dollar basis by the application of a broadly accepted index of general prices." Professor Graham further states that "net income based on 'adjusted historical cost' is also a clear-cut, definite concept . . . the excess of revenue, expressed in current dollars, over the incurred cost of the capital (assets and services) consumed in producing that revenue, expressed in the same sized current dollars."

There are several advantages of the adjusted historical cost method. One is that the primary financial statements, as prepared by management and verified by independent accountants, can continue to reflect historical dollar costs if this is desired. The committee of the American Accounting Association has so recommended. The conversion of the conventional financial statements to reflect the changes in the price level is accomplished without changes in the books of account. The American Accounting Association has issued two publications which explain and illustrate the technique to be used in making the price-level adjustments. The first of these publications is entitled "Case Studies of Four Companies," which was prepared under the direction of Professor Ralph C. Jones and was published in 1955. The other publication is a pamphlet on "Basic Concepts and Methods" prepared by Professor Perry Mason and issued in 1956. This later pamphlet provides a brief explanation of the problem and illustrates the technique which was used in the case studies.

The committee of the American Accounting Association believes that it is essential to full disclosure to adjust all of the items on the financial statements to the current dollar amounts. By use of a general price index, such as the Consumers' Price Index of the U. S. Bureau of Labor Statistics, the various items on the income statement and on the balance sheet are converted to current dollars. As illustrated by Professor Mason in "Basic Concepts and Methods," this procedure of conversion starts with the published price index numbers which are converted into a purchasing power index and the latter is expressed decimally with the current date as the basis for reference. The resulting decimals, known as conversion factors, can be applied easily to the historical cost amounts requiring adjustment. For example, if the price index has doubled since the date of acquisition of the plant assets, the conversion factor will be two and the valuation of the plant assets on the adjusted historical cost basis will be twice the book amount of historical cost. Similarly, if the same change in price level has taken place since the capital stock was issued, the adjusted balance sheet will show the capital stock account at twice as many dollars as were paid in at the time of issue. Bonds or other long-term obligations, however, will not be adjusted at the balance sheet date because these, and the other liabilities to outsiders, now might be paid with current dollars. Extensive adjustments also are made on the income statement.

Several advantages may be suggested for the adjusted historical cost method. First, it offers considerable convenience and flexibility in ascertaining and refining the adjustments. Because these adjustments ordinarily are not to be placed upon the books, decisions as to refinements do not have to be made in advance of preparing the conventional financial statements. Second, on the whole it is probable that the best purpose is accomplished by basing adjustments upon an index which measures the general level of prices rather than on indexes which measure price changes in specific commodities or types of commodities. Were the latter type of index to be used, the corrections would result in the use of replacement costs at the current market, which, in the case of plant assets particularly, may not be the costs when the so-called "replacements" occur. Actually, literal replacements seldom, if ever, happen. Third, by applying a general purchasing power index to the original historical costs, the resulting financial statements are still on the basis of original cost, although adjusted to current monetary units. The *principle* of original cost still endures. The only change is in the *measurement* of original cost, which is done at approximately current dollars rather than partially at out-of-date dollars. The resulting profit has been determined on the cost principle; current revenues have been reduced by the cost of current expenses, which are all expressed in monetary units having the same general purchasing power as those in which the current revenues are stated.

American Studies

As yet there has been little, if any, use of the adjusted historical cost, or of any other method of adjusting for price-level changes, among accountants and business enterprises in the United States. One of the four companies studied by Professor Ralph C. Jones [1] has continued the study and has published the adjusted figures as a supplement to its annual statement. One of the other companies that was included in the studies has made subsequent references to the variation between the rate of return on present-day values and on book values.

Interest in the effects of the changing price levels upon business profit appears likely to vary according to the amount of inflation currently experienced. The problem receives little attention if prices are relatively stable or slowly creeping upward. Interest is stimulated when prices are advancing rapidly, as was the case in the United States during the six years from 1946 to 1951, inclusive. The average annual increase in consumer prices was 6.4 per cent during this period. In contrast, this was followed by a period of price stability during the four years of 1952-1955, inclusive.

In 1948 a Study Group on Business Income was organized by the American Institute of Accountants for an intensive study of the uses of the word "income" and "terms associated therewith in accounting and in business, economic, and political fields." Outstanding accountants and economists comprised the study group, whose report was published in 1952 under the title "Changing Concepts of Business Income." A majority of the group recognized the need for accounting statements that would be more broadly

[1] "Case Studies of Four Companies," Ralph Coughenour Jones, American Accounting Association, 1955.

meaningful by measuring profits in units of equal purchasing power during periods when the value of the monetary unit was not stable. The conclusion was expressed that methods should be developed to expand the framework of accounting to recognize the changes in value, but that for the present, the primary statements of income should continue to be on bases now commonly accepted. It was suggested, however, that corporations should be encouraged to furnish information to stockholders which will facilitate the determination of income measured in units of approximately equal purchasing power. The report did not indicate the methods to be followed in obtaining this information for the stockholders.

Apparently, as yet the report of the Study Group has had little, if any, effect upon accounting methods in the United States. Nevertheless, we cannot conclude that the work of the Study Group and of the committee of the American Accounting Association has not been important or beneficial. The research, the thinking, the exchange of ideas all have resulted in publication of useful materials. It may be that the use of the work of these pioneering groups will be delayed until another inflationary period is upon us. Even at such a time many businessmen will be slow to change their accounting methods or to interest themselves in supplementary information unless it is useful in reducing their income taxes. Among American business executives and accountants, the concept of profit that receives the chief attention is "taxable profit."

Lifo and Income Determination

The importance that income taxes have upon our accounting thinking in the United States is evidenced by the growing use of the Lifo method of accounting for inventories and cost of sales. In 1949 less than twenty per cent of the companies surveyed by the research department of the American Institute of Accountants and reported upon in "Accounting Trends and Techniques" were using the Lifo method. In the ninth edition of this survey, it is shown that almost one-third of the 600 companies surveyed were using Lifo in 1954.

The Lifo method is generally referred to as a cost method. As to the balance sheet, it results in an out-of-date cost if prices are changing. If prices are rising, the cost of unsold merchandise will be too low in relation to current dollar calculations. In periods of declining prices, however, inventories will be priced too high if these out-of-date cost valuations are used.

The principal justification for Lifo is in its effect upon profits, and upon the income taxes on these profits, when prices are rising. The amounts charged to cost of goods sold are for the latest purchases and tend to be, or to approximate, current replacement costs. Thus, the level of prices at which the cost of sales is stated is near to the same level as that at which the sales are stated, particularly if the physical goods sold are "replaced" near to the time of the sale.

The inconsistencies of Lifo are fairly obvious. In order to use current values for the cost of goods sold, the balance sheet must use "ancient" values, which may either be lower or higher than current prices depending upon the forces of inflation or deflation. Also, the use of a replacement value in the cost of sales depends upon the occurrence of replacement within the accounting period. If

specific items are not replaced until later, the last-in-cost may be a prior, out-of-date cost. Furthermore, the Lifo method is not likely to be popular during a period of deflation. In fact, under the "cost or market, whichever is lower," method it then will usually be replaced by market.

Time of Income and Expense Recognition

Turning from the problem of the effect of general price changes upon profits, we shall now consider questions that arise because of dormant risks involved in reporting profit according to annual or other periods of time. It should be noted that the adoption of a "natural business year," rather than the calendar year, may diminish the problems of assigning income and expenses to the proper accounting period. Also, these problems would not require attention if the cash basis were acceptable in recognizing profits. Actually, the cash basis is used by a considerable number of business enterprises, except that depreciation usually is recognized. For example, in farming operations, the accounting is likely to be essentially on the cash basis. Among professional people, such as doctors, attorneys and even accountants, the recording of income sometimes awaits its receipt in cash, and the recognition of expenses, except depreciation, may occur only when cash is paid out. Other businesses that render personal services, such as real estate agents and insurance brokers, sometimes use accounting methods that are essentially on the cash basis.

The cash basis is an acceptable basis for income tax purposes in the United States. This, of course, has encouraged its use, particularly where there are uncertainties as to the realization of the income. For example, farmers seldom inventory the growing crops and therefore have no accumulated cost values for the unsold harvested crops. This may be due partly to the hazards of farm prices, and partly to accounting inertia. Nevertheless, for financial reporting purposes the cash basis is not acceptable, because it does not match revenues with expenses in the period to which they both belong.

The accrual basis is essential but it raises many questions as to the time when income is to be included, and when the expenses and provisions for losses are to be deducted to ascertain business profit. Some risks can readily be ascertained and provided for, but in other cases accounting options appear to exist, although sometimes a logical justification may not be evident. For example, a complete accrual basis would require that profit on installment sales be recognized fully at the time of the sales with appropriate provision for collection risks. Yet there are occasions when the risks of collection are such that all profit is deferred until cost has been recovered, while in other instances each collection may be treated as partly a recovery of cost and partly a receipt of profit. From a theoretical point of view there appears to be no difference between sales "on account," without initial or "down" payments and without specified dates for installment payments, and sales that provide for such installment payments. If the sale is complete and no service remains unperformed, the time for recognizing income and for recognizing and providing for the risks of collection has arrived.

Provision for the risk of loss on accounts receivable is a required procedure but is this true for the risk of

obsolescence and supersession of merchandise? Admittedly, the provision for obsolescence is required if it actually has occurred, but this is for an accomplished event. It is not for the risk that future obsolescence may occur or be discovered. There may be items of merchandise in stock which gradually are being superseded. Ordinarily, obsolescence or supersession is not a sudden occurrence; new products gradually are accepted and replace the old. But the occurrence of complete obsolescence may happen suddenly even though the unrecognized event or events responsible for it occurred in a prior accounting period. It is the risk that such events are occurring which is not provided for in the usual provisions for obsolescence of merchandise.

Many manufacturing concerns engage continually in research and experimental work with the expectation that future benefits will result. Because of the uncertainty as to the benefits which will be obtained and as to the duration of these benefits, common practice is to choose between two options. Usually it is considered practical to charge such expenditures to current expense, particularly if the company engages continuously in experimental and development work. It is generally considered to be permissible, however, to capitalize these expenses during the course of a specific project and to write them off if the project is unsuccessful when that fact is ascertained. If the project is beneficial, the capitalized costs may be charged to operations by amortizing them on a time basis or according to the expected production. It is likely that the total time, or sometimes the quantity of production, chosen as the basis for the annual write-off will be determined arbitrarily. In fact, in most cases the uncertainties will encourage the method of an immediate charge-off to expense. But, under either method, the result is likely to be an arbitrary, instead of a scientific, determination of profit.

In appraising the losses for which provisions are needed in ascertaining the profit of one year, changes in the business cycle may need to be anticipated if possible. In prosperous "boom" periods of production, recognition should be given to the possibility of a depression or recession in activity. The allowance for loss in the collection of receivables, for example, will need to be larger if collections will extend into a period of hard times. The least desirable merchandise may sell in a period of great activity when quantities are inadequate, whereas types of items that seemed very popular during prosperity may be found to have been superseded when merchandise stocks are found to be adequate or excessive.

It is well known that the profits under fixed-price contracts for long-term construction projects are hazardous to estimate in periods of inflation. Logically, the total profit should be apportioned over the period of the contract on a percentage-of-completion basis, instead of being recognized only upon fulfilling the contract. But this requires provisions for increasing costs and for other non-calculable risks. Even if no inflation is occurring during a period of full employment and production, work stoppages may be caused by a lack of materials or by a shortage of skilled workmen. The danger of strikes is greater at this time. Theoretically the risks should be recognized and provided for, but this seldom is possible until the arrival of the events causing the losses.

Economic Profit, Taxable Profit and Accounting Principles

In the United States, the difficulties encountered have resulted in a general recognition of the concept of "generally accepted accounting principles" in preference to an insistence upon adherence to economic concepts of profits. The principles to be used in ascertaining profit, according to this doctrine, must be generally accepted. It does not need to be shown that they are sound or even logical in all particulars. Merely, they must have found general acceptance among accountants and businessmen. Sometimes choices or options exist as to the generally accepted principles. Often the particular circumstances affect the options, limiting the application of the principles.

These accepted principles are not immutable. They are not unchangeable laws. Rather they are rules that have evolved from the thinking of men which have come to be accepted, at least temporarily. In fact, very important changes have occurred; one example is in the accepted principles for valuing inventories, which were first expanded to include "cost or market, whichever is lower" and now include "Lifo" as a method of costing.

The principles that receive recognition undoubtedly have been influenced by economic concepts of profit. The need for price level adjustments, for instance, is gaining some recognition. But another influence, which often supersedes the concepts of economic profit, is that of "taxable profits."

As a practical matter, businessmen and corporate investors are justified in their interest in taxable profits because only about one-half of these profits remain after federal and state income taxes. In some respects the divergence between economic and taxable profit is so great that one can scarcely justify the use of the word "profit" in both instances. Taxable profits have been determined mostly by legislators, although partly by court interpretations. In too many cases the rules prescribed by the legislators have resulted from propaganda for reductions, exemptions and special privileges. In our latest Revenue Code, in 1954, a little progress was made in changing a few sections to conform with generally accepted accounting principles. Unless taxable profit is determined according to these accepted accounting principles, it cannot be used for reporting the financial results, except in income tax returns. Too often this limitation is overlooked in financial accounting.

But the taxation of business profit which has been ascertained according to current concepts of generally accepted accounting principles would not prevent the partial confiscation of economic wealth. Accepted principles today fail to require adjustment for changing price levels in periods of inflation. For instance, an investor who invests $100,000 in capital stock and receives $200,000 either upon liquidation of the corporation or upon sale of the stock is taxed on $100,000 as a capital gain. It does not matter if the liquidation dollars are worth only one-half what the invested dollars were worth in purchasing power, so that there is no economic profit. The monetary result is the measure of the taxable profit. And if dividends are received out of monetary profits where in fact no economic profit has occurred, these also will be partly "confiscated' by income taxes which may be as high as 91 per cent at present federal rates of tax.

Summarizing to this point, this paper has argued that both the corporate investors and the management executives who have the stewardship of business should be interested in ascertaining periodically the economic profit rather than the monetary profit. For this, the preparation of accounting statements on the basis of adjusted historical cost is urged. It is believed that this method is more useful in approximating the economic profit than the method of replacement cost. Another problem in ascertaining profits arises from arbitrary divisions of the life of a business into years or other periods of time. In determining the profit of each period it is probable that too little attention has been given to the most uncertain of income and expense items. Risks that can be calculated must be provided for and expense and income accruals must be made whenever dependable estimates are possible. Other risks that cannot be calculated far in advance of governing events may logically await recognition. Although concepts of economic profit have received some attention from accountants and businessmen, currently the ascertainment of profit in the United States is based upon generally accepted accounting principles. Unfortunately, concepts of taxable profits do not as yet always coincide with either the economic concepts or the generally accepted accounting principles.

International Differences in the Reporting of Profits

Increasing interest in foreign investments, both by corporations and by individuals or groups of individuals, creates a greater interest in the reporting of profits by companies in countries other than the United States. Americans have good reason to work toward international understanding and agreement upon the basic principles to be followed in reporting business profits. It is important that the word "profit" should mean substantially the same thing in all countries, or be described with unmistakable clarity, when the investment field crosses international boundaries.

From this international viewpoint, however, it is unfortunate that a universal concept of basic principles in the ascertainment of profit, and even in the approach to the determination of basic principles, has not developed. The approach differs partly, at least, because of differences in the authority and emphasis of governmental functions. In some countries the regulations promulgated by governmental agencies prescribe the only rules for determining profit. This is particularly likely to be true in those European countries where governments are socialistic or tend to regulate business. Even in central Europe, as in Austria and Switzerland, this approach to the stating of profits was admitted at the International Congress. This, of course, is in contrast to the situation in the United States where generally accepted accounting principles do not depend upon the edicts of governmental agencies.

A second hurdle obstructing an international uniformity in accounting principles exists in the differences in standards of reporting financial information and in attaining an objectivity which is independent of the business executives or directors. Businessmen universally have become tax conscious, but unfortunately in some countries this is the paramount factor in reporting profits. Notwithstanding the attempts of governments to regulate, in some countries it is probably

that "net profit" is determined to quite a large extent by what management wants to show, and therefore by what it wants to hide. We should hasten to repeat that this is true only in some countries. Nevertheless, in many countries over-conservatism has not been outlawed as a vice, and the providing of reserves for unforeseen events appears to be quite acceptable. "Secret" reserves were not approved by the speakers at the Congress, but the need for mentioning the use of such a "reserve" by some of them suggests the existence of a contrary point of view.

Even in the United Kingdom until nine years ago extreme conservatism amounting to understatement apparently was considered a virtue. In his paper, the speaker from Scotland stated: "Prior to the passing of the Companies Act, 1948, the balance sheet of a U. K. company showed a legally 'true and correct view' of the state of affairs even if the fixed assets had been over-depreciated, the stock-in-trade undervalued, and the liabilities swollen by provisions for unimaginable contingencies. There was no statutory obligation that the profit and loss account should be 'true and correct' and it was not illegal to make undisclosed transfers to hidden reserves before striking the disclosed profit of the year." That writer also stated that the 1948 Act for the first time gave attention to "the contents of the profit and loss account and somewhat rigid regulations were included, designed to disclose the 'true and fair' profit of each year. . . ." Thus, it seems fair for us to conclude that greatly improved conditions have been obtained in Great Britain by the outlawing of hidden reserves, but an examination of recent financial statements shows that all special or general reserves for possible contingencies have not been eliminated.

Inflation has been a difficult problem in many countries. Probably the most progress in recognizing and providing for the effect of inflation has occurred in the Netherlands. As mentioned in the foregoing, it is an accepted method in the Netherlands to present the plant, property and equipment at current replacement values, less depreciation, and the inventories also at replacement value. Profits, therefore, are determined by using depreciation on replacement values and by charging the cost of sales with the replacement cost of materials and other production elements. Price indexes are used to obtain the current replacement values.

The Netherlands do not appear to favor the capitalization of intangible assets. For example, a recent financial report of the big N. V. Philips' Gloeilambenfabrieken shows that research, development costs and patent expense, as well as amounts paid for goodwill, are written off immediately. Securities owned are valued at purchase cost or market values at the end of the year, whichever is lower. Although all of these accepted methods do not appear to be allowable for income tax purposes, there are indications that some concessions have been made in allowing charges for inflated capital costs.

In his paper, the author from Belgium recognized the existence of a variety of methods of valuation. He proposed to the Congress that it should define very clearly the different valuation methods for raw materials, goods in process, finished goods and fixed assets, and that these several definitions should be gathered into a code to which accountants

should refer in their reports. Also he recommended that changes in valuation methods should receive particular attention with a disclosure of the "resulting incidence in figures." The Seventh International Congress did not act upon his suggestion.

Certainly the first step toward adequate international reporting is the recognition and revealing of differing methods of valuation with a clear statement of the effects of changes in methods. Although this is an accepted principle of reporting in the United States, there are many other countries that have not achieved this "first principle." It is to be hoped that, by the dates of the Eighth International Congress five years hence, the accountants in many countries will have recognized and adopted the principle of full disclosure of the methods used and their significance in reporting profits.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

TAX ASPECTS OF ANNUITY AND LIFE INCOME CONTRACTS WITH CHARITABLE ORGANIZATIONS

Introduction

In the past two decades we have seen our income tax grow from what was formerly a rich man's nuisance to the giant that it now is. For many individuals the payment of Federal income tax constitutes the largest annual expenditure in their budgets. Because of this, numerous heretofore unheard of types of business and financial transactions have been resorted to in an effort to reduce taxes.

Two basic rules of the income tax law which give rise to many such imaginative transactions are (1) the deduction allowed for charitable contributions and (2) the capital gains tax imposed on the sale of capital assets.

A particularly advantageous provision in the tax law allows a person to make his charitable contribution in the form of appreciated property and deduct (up to 30% of adjusted gross income) the current market value of the asset rather than the donor's original cost. Perhaps an illustration will point out the advantage of this provision. Assume a taxpayer in a 50% tax bracket owned stock which had increased in value from an original cost of $20 per share to a current value of $100 per share. If the taxpayer sold this stock he would realize $80 in capital gain on which he would pay $20 tax. Assume, however, that instead of selling the stock it is given to a qualified charity. The taxpayer can deduct $100 on his tax return, thus saving $50 in tax. The $100 gift to a charity has cost him $30. This is the difference between the $80 net after tax that he would have received had he sold it and the $50 in tax-saving that he obtained by giving it away. In recent years taxpayers have turned to more elaborate transactions whereby tax savings can be realized from gifts to charitable organizations. Two categories of such transactions are: (1) gift annuities, (2) life income contracts. These two categories will be discussed in order.

Gift Annuities

This type of transaction takes the form of a gift to a charitable organization in return for a promise by the charity to pay a certain sum each year to the donor for life.

Many universities and churches have found charitable annuity programs to be valuable aids in their fund raising programs. The prospect of immediate savings in income taxes without loss of income proves to be strong inducement for a current gift to charity of property which would not otherwise be given to the charity until the donor's death, if then.

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The potential donor, upon becoming interested in a charitable annuity, may be expected to ask the following questions: (1) How much of the value of the donation will be deductible? (2) Will any capital gains tax be incurred on the transfer? (3) Will the annuity payments received in return for the gift be subject to tax?

Obviously a taxpayer will not be allowed a full deduction on the one hand and tax-free income on the other.

The Treasury Department and the courts have consistently held that charitable annuity transactions are composed of two elements, the giving of a donation and the purchase of an annuity. The consideration paid to the charity is accordingly divided into two parts and a charitable deduction is allowed for that portion of the gift which is in excess of the present value of the annuity received in return. This "present value" was ascertained in the leading case of *Anna L. Raymond* 40 BTA 244, (1939) by looking to the price at which a similar annuity could be purchased from the five leading insurance companies. The court in arriving at this price used the 1937 Standard Annuity Mortality Table as an indication of what the five leading insurance companies would charge.

Thus, if a donation of $10,000 was given to a charitable organization by a man 50 years of age in exchange for an annuity of $390 per year as long as he lives, the annuity would be valued by the Treasury Department according to the table (with interest at 2%, lives set back one year and 6½% loading) at approximately $7,800. The $2,200 difference between the present value of the annuity and the donation would be deductible as a charitable contribution. Assuming the donor is in a 50% tax bracket he will realize $1,100 (50% of $2,200) of his $10,000 investment the first year.

Since the decision in the Raymond Case, the Treasury Department has continued to employ the 1937 Standard Annuity Mortality Table in the face of criticism on the grounds that it is no longer representative of what the five leading insurance companies would charge. Further, even if it were representative of insurance company rates, it is argued that it is not logical to value charitable annuities on the basis of insurance company rates. The use of the table at a 2% rate results in an over-evaluation of the annuity thereby attributing a greater portion of the donation to the purchase price of the annuity and a correspondingly lower portion to the gift element or, in other words, it tends to reduce the charitable contribution deduction.

Turning to the situation where the donation is made in the form of appreciated property we encounter further complications. If the value of the annuity exceeds the donor's basis in the donated property, is there a taxable gain? If so, when is it recognized? Suppose that instead of giving $10,000 in cash, the man in the example above donated stock which cost him $5,000 but had a market value of $10,000. The Treasury Department would value the annuity at $7,800 and the charitable contribution would be $2,200. However, inasmuch as the stock had a cost, or basis, to the donor of only $5,000 and he received in return an annuity worth $7,800 the Treasury Department would consider the transaction a taxable exchange resulting in capital gain to the donor of $2,800.

Much confusion has arisen as to when the capital gains tax on the

difference between the cost of the stock and the present value of the annuity (the $2,800 in our example) is incurred. There is authority tending to indicate that the capital gains tax would be deferred until sufficient payments under the annuity contract had been received to permit the donor-annuitant to recover his original cost in the stock ($5,000 in our example) in tax-free income. Thereafter he would pay a proportionate amount of the capital gains tax as he received each payment until he had paid the capital gains tax on the entire $2,800 gain. It should be pointed out that this is the established rule where an annuity is purchased from an *individual*.[1] There is indication that this rule will apply also to the purchase of annuities from organizations which are insolvent or in dubious financial condition. The rule is based on the fact that there is no way of measuring the present value of such an annuity contract since there is no assurance that the contract will be fulfilled. Therefore, the annuitant has not realized capital gain until he has actually received sufficient payments to recover his basis in the property constituting consideration for the annuity.

Since the rule is based upon the difficulty in ascertaining the present value of the annuity because of the uncertainty of payment, it would not logically apply to annuity contracts acquired from established and financially stable charitable organizations. Colleges and universities are normally permanent in nature and little risk is faced in the purchase of annuity contracts from them. Such an annuity contract accordingly has a positive value which can be easily ascertained by comparison with established rates charged by the other organizations. It is therefore evident that in our example the donor-annuitant has realized gain in the amount of $2,800 immediately upon entering into the transaction. Accordingly, he would have to pay the full capital gains tax in the year the transaction was entered into.

It should be noted that the donor-annuitant is taxed only on the difference between the cost of the property and the present value of the annuity. He is not taxed on the difference between the present value of the annuity and the market value of the property. Or, in terms of our example, the annuitant pays tax on the difference between the cost of $5,000 and the present value of the annuity of $7,800 but does not pay tax on the difference between the $7,800 and the $10,000 market value of the property. He therefore is saving capital gains tax on $2,200 of the $5,000 increase in the value of his property and is also getting a charitable contribution deduction for the same $2,200. Assuming the donor is in a 50% tax bracket his charitable deduction will result in tax saving of $1,100. The saving in capital gains tax is $550, and thus the cost of his gift to charity has been reduced by $1,650.

Turning to our donor's third question as to the tax to be expected on receipt of the annuity payments, we find that the usual tax treatment of annuities under Section 72 of the Internal Revenue Code appplies to charitable annuities. The donor-annuitant's investment in the contract (the "present value" of the annuity) is spread over the remaining years of his life and a prorata portion is allowed to be recovered tax-free each year. The balance of each year's an-

[1] Comm. v. Bertha F. Kahn (49-1 USTC 9271)

nuity payment, over and above the excludable portion, is in effect interest and is taxed accordingly as ordinary income.

The following examples will serve to further illustrate the tax savings that can result from gift annuity transactions. In these examples the annuity payments to be received by the donor-annuitant were computed according to uniform gift annuity rates adopted by the Ninth Conference on Gift Annuities in October, 1955. For tax purposes, however, the "present values" of the annuity payments have been computed according to the table used by the Treasury Department; more precisely, the 1937 Standard Annuity Mortality Table with interest at 2%, ages set back one year and a 6½% loading. Further assumptions are listed in each example.

Illustration No. I

(A) Mr. X who is 65 years of age and has taxable income which places him in a 75% income tax bracket, donates stock which cost him $25,000 but is now worth $50,000, to a charity. In return he recives an annuity of $2,500 per year. The present value of this annuity for tax purposes is $31,915. He has therefore received a capital gain of $6,915 (the difference between $25,000 and $31,915) which will result in tax of $1,729. He has also acquired a tax deduction of $18,085 which will save him $13,564 in his current year's income tax. The net tax savings for the current year will be $11,835, ($13,564 less the capital gain tax of $1,729). The end result of the complete transaction is a gift to charity of $18,085 made at a cost of only $6,250 to the donor.

(B) Had Mr. X sold the stock instead of donating it he would have incurred a capital gain of $25,000 resulting in a tax of $6,250. Assuming an annuity costing $31,915 was purchased and a cash contribution of $18,085 was made the tax savings would be $13,564. The end result will be a gift to charity at a cost of $10,771 instead of $6,250. By giving the stock to the charity instead of selling it, our taxpayer has saved $4,521. In the latter situation the charity would immediately have the exclusive use of $18,085 compared with the eventual use of about $30,000.

	A	B
Gift	$18,085	$18,085
Capital gains tax	1,729	6,250
Tax savings as a result of deduction	13,564	13,564
Annuity purchased	31,915	31,915
Net cost of gift to donor	6,250	10,771
Tax Saving	4,521	

Illustration No. II

(A) Mr. Y who is 70 years of age and has taxable income which places him in a 90% tax bracket donates stock which cost him $100,000 and is now worth $300,000, to charity. In return he receives an annuity of $16,500 per year. The present value of this annuity for tax purposes is $173,910. Mr. Y has received a capital gain of $73,910 which will result in a tax of $18,478. He has acquired a tax deduction of $126,090 which (provided it does not exceed 30% of his adjusted gross income) will save him $113,481 in the current year's taxes. The net savings will be $95,003. The end result of the complete transaction is a gift to charity of $126,090 made at a cost of $31,087.

(B) Had Mr. Y sold the stock instead of donating it he would have realized a capital gain of $200,000 resulting in a tax of $50,000. Assuming

an annuity costing $173,910 was purchased and a cash contribution of $126,090 was made, the savings in tax will still be $113,481. However, he has incurred $31,522 more in capital gains tax which would not have been incurred had he given the stock to the charity rather than selling it.

	A	B
Gift	$126,090	$126,090
Capital gains tax . .	18,478	50,000
Tax savings resulting from deduction .	113,481	113,481
Annuity purchased .	173,910	173,910
Net cost of gift to donor	31,087	62,609
Tax saving	31,522	

Under A and B of both examples the annual annuity payments and the tax thereon would be the same.

To summarize the tax treatment of gift annuity transactions we can state the following rules:

1. If cash is given for an annuity:

The donation is apportioned between the charitable contribution element and the purchase price of the annuity. This purchase price then becomes the investment in the contract for computing income tax on the receipt of annuity payments and the contribution element is deductible.

2. If appreciated property is given for an annuity:

The market value of the appreciated property is apportioned between the charitable contribution element and the purchase price of the annuity.

If this purchase price exceeds the donor's original cost in the asset he will realize capital gain on this difference and will incur capital gains tax liability in the year of the transaction.

The difference between the present value of the annuity and the market value of the property constitutes a charitable contribution and is deductible as such.

Life Income Contracts

This category encompasses a variety of forms which are somewhat like variable annuity contracts in some respects and are comparable with trust agreements in other respects. In general, they are gifts of property or money to a charity with a reservation of a life estate in the income from the property. The main distinction between life income contracts and annuities lies in the fact that under a life income contract the payments to the donor vary from year to year according to (but never exceed) the income earned by the property. Because life income contracts do not come within the definition of an annuity under the Internal Revenue Code, the tax treatment given to life income contracts varies considerably from that given to annuities. The Treasury's view is that these transactions represent gifts made to charity subject to a life estate in the income. This means that the full amount of the income received each year by the donor normally will be included in his income subject to tax. It also means that if the donation is in the form of appreciated property the tranferor-donor will not realize any capital gain.

The amount of charitable contribution deduction that is allowed is the market value of the property given less the value of the retained life estate or, in other words, the present value of the remainder interest. This is to be ascertained by referring to Table I Section 86.19(f) of Gift Tax Regulations 108.

A recent innovation in this area promises real tax savings. Recently it is reported that a college in California obtained a ruling from the IRS which held that the donated property could be sold by the charity, the proceeds invested in municipal bonds and the income therefrom would retain its tax exempt status when distributed to the donor. Thus, the donor gets an immediate charitable contribution de-

duction, he pays no capital gains tax and receives tax exempt income.

The following examples will illustrate the possible tax advantages of this type of transaction.

Illustration No. I

(A) Mr. X is 65 years of age and has taxable income which places him in a 75% tax bracket. He donates stock which cost him $25,000 but is now worth $50,000, to a charity under a life income contract whereby he reserves a life estate in the income. Assuming a 3½% return he will receive $1,750 per year in tax-free income. For tax purposes, the value of the remainder interest will be $33,290. Mr. X will receive a deduction of $33,290 which will result in a savings of $24,968 in the current year's tax. Mr. X will incur no capital gains tax.

The fair value of the stock $50,000 less the income tax saving of $24,968 is $25,032. The annual return of $1,750 results in a rate of return of about 7%.

Illustration No. II

(A) Mr. Y who is 70 years of age and has taxable income placing him in a 90% tax bracket donates stock which cost him $100,000, but is now worth $300,000, to a charity under a life income contract. Assuming a return of 3½% he will receive $10,500 per year in tax-free income. The value of the gift of the remainder interest is $217,890 which will provide him with a savings of $196,101 * in the current year's taxes. The net cost of the gift to him will be $103,899.

Mr. Y has in effect sold his stock for $196,101 in cash plus an annual income of $10,500. On his investment of $103,899, he will receive a rate of return of approximately 10%, tax free.

To summarize the tax treatment of life income contracts, we can state the following rules.

1. If cash is given for a life income contract—

> The donor will receive a charitable contribution deduction for the difference between the cash contributed and the value of his life estate in the income therefrom.
>
> The income will be fully taxed as it is received unless it is tax-free interest.

2. If appreciated property is given for a life income contract—

> The donor will receive a charitable contribution deduction for the difference between the market value of the property contributed and the value of his life estate in the income therefrom.
>
> The income will be fully taxed as it is received unless it is tax-free interest.
>
> No capital gain will be realized even though the market value of the property greatly exceeds the donor's basis therein.

Conclusion

We have dealt at some length with the income tax aspects of gift annuities and life income contracts. A word of caution appears appropriate here lest we become blinded by the prospects of tax savings and fail to consider the many other facets of such transactions. Only in certain situations will the tax advantages be material enough to offset the non-tax disadvantages. Each individual situation should be analyzed from the standpoint of the desires and objectives of the prospective donor.

Comparing the annuity contract with a life income contract we find that both have their advantages and disadvantages. While the annuity contract may provide a more definite income than would a life income contract, the latter will generally result

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* In this example the donor would have to earn approximately $600,000 per year in order to deduct the full $217,890 the first year. If his income is not this high, he should make his donation over two or more years.

in a larger charitable deduction. All income payments received under a life income contract can be fully tax-free whereas only a portion of each annuity payment is tax-free. If appreciated property is given, no capital gains tax will be incurred under a life income contract whereas under an annuity contract substantial capital gains tax may be incurred.

BUDGETING BILLIONS

By Maurice H. Stans

A few weeks ago, in one of our American cities, the local officials were planning a new public works project—a bridge across the river. They discussed location and design and construction and cost, and then got around to financing. Part should be paid by the city, part by the county,—they said—part by the suburbs and part by the State. But the question was: How much by each? It was a knotty problem, and there were differences of opinion, because no matter what the division it meant more State, county and local taxes. No one was happy and there was no solution in sight until one fellow at the end of the table got up and said brightly: "Let's get the money from Washington—then nobody'll have to pay for it!"

Like the preacher with his Sunday sermon, I'd like to take those words as my text for tonight: "Let's get the money from Washington—then nobody'll have to pay for it!"

I am continually amazed by the extent to which this fallacy has affected the thinking of many Americans. Some people apparently think that the Federal Treasury is a free-flowing well from which funds can be drawn in any amount for all purposes. And this fallacious notion feeds on another—that it is always the other fellow's money which will be used for the things we might want.

As accountants, you know better. That's why I am especially pleased to be here, among my old friends in the auditing profession in Illinois, and to have the opportunity of talking to you about today's fiscal problems of the Federal Government. You can help, if you are willing, to dispel some of these fallacies and thereby help the American public to understand some of the hard realities of budgets and taxes. Such understanding is one of the country's great needs today.

I sometimes get the feeling that the 173 million stockholders in the biggest enterprise in the world—the United States Government—don't bother to read their financial reports. In the investment world, you know, a person who holds one share of stock is called an "Aunt Jane" and usually may be counted on to speak up at the annual shareholders' meeting. Well, every taxpayer is a potential "Aunt Jane," and if more of them got up and asked questions there might be an entirely different state of mind in the profession of national politics.

As you know, budgets are financial plans. That's true if we speak of personal budgets, family budgets, business budgets, or the Federal budget. They all deal with the same

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questions: How much do we expect to take in? How much do we plan to spend? And, importantly, what will we spend it for?

In the case of the Federal budget, how much we spend and what it goes for mirror our overall national policies, affecting our leadership of the free world, our national security, and our national welfare. Carrying out these policies requires many billions of dollars—dollars which come from each of us when we pay our income taxes, and when we buy goods and pay Federal excise taxes. And don't forget that the taxes paid by corporations are costs which are ultimately paid by the people, too.

Historical Background

Years ago there wasn't so much concern or interest in what the Federal Government did or in how much it cost. Federal activities were few and they were not very expensive. Furthermore, a large part of their cost was paid for from customs receipts. As a matter of fact, for about 130 years the Federal Government had no budget at all, as we know it today. Until the early 1920's, the departments and agencies sent their financial requests each year to the Secretary of the Treasury who had them printed without change and sent to the Congress. No consideration was given to how the programs of one agency related to those of another, or to the total amount that all the agencies together were requesting. Under that simple process, preparing what was called the Treasury's "book of estimates" took the time of only one employee.

Of course, Federal budgets in those days were very different from what they are now. The cost of all the Government's activities in 1916, for example, was only about half of what we now spend in one week. The structure of government was simpler and our wants were more moderate. Total budget expenditures in the fiscal year 1916 amounted to 713 million dollars. We are spending about 11 times that much now for interest on the national debt. Now our average *weekly* spending comes to about 1½ billion dollars, and we finance it mainly through income taxes.

With the advent of World War I, annual Federal spending permanently passed the billion-dollar mark, and the long-run trend has been upward ever since. In fiscal 1917 expenditures were just under 2 billion dollars; forty years later, in fiscal 1957, they were more than 69 billion dollars. Similarly, the share of the Government in the economy has risen during these years. In 1917, Federal spending amounted to less than 5 percent of the national income; last year it was 20 percent.

Nowadays the process of preparing the Federal budget bears no resemblance to the haphazard methods of the past. The budget process today is a testing and screening of all Federal programs—those currently carried on and those proposed for meeting new needs or problems. Many months are spent in the examination and review of the various activities and their cost. Within the general framework of the fiscal outlook, a careful analysis is made of international and domestic conditions and needs. Various and often conflicting viewpoints are reconciled. Program A is weighed against program B, and priorities are set.

From this process emerges an integrated prospectus for meeting national objectives, as finally determined and recommended by the

President. In our system of government, the Congress has full power to change this plan. The Constitution specifically provides that no expenditure shall be made except "in consequence of appropriations made by law." Similarly, the Congress decides how to raise the money the Government will need—through taxes, other charges, or borrowing. The President recommends the amounts to be spent for national security, for agriculture, for veterans, for natural resources, and for other programs that the people want the Federal Government to undertake for them and are prepared to pay for. But the Congress appropriates the money.

I have mentioned the dramatic increase in the size of the budget in recent decades. The needs of national security have been a major factor in bringing about this increase. Concurrently, there has been a growing tendency among our people to rely more and more on the Federal Government for the solutions to all problems,—even if they are essentially State or local questions or could be handled by nongovernmental action. If this tendency continues unchecked, it can only lead to bigger and bigger Federal budgets accompanied by high taxes in the future.

I think there is a genuine need for some soul-searching about Federal activities with a look to the years to come. This involves, among other things, considering the proper relationship of the Federal Government to private enterprise and to State and local governments.

Relationship to Private Enterprise and State and Local Governments

Our Federal budget can be considered, first, as a reflection of how we as a people are choosing to divide activities between public agencies and private enterprise. Our strength and our freedom in this country are greatly dependent on individual effort and the maintenance of the right atmosphere for encouraging private initiative. Government should not get in the way of economic growth and stability.

This means that the Government's role should be to stimulate, rather than dominate; to reinforce, rather than replace, our free market system.

Of course, in that type of system, the responsibility works both ways. When private enterprise fails to meet the needs of our citizens, they are likely to demand Government action. When one segment of private enterprise demands special favors from Govermnment—subsidies, special tax concessions, or tariffs, for example—it is creating economic distortions which may damage the long-run strength of our system. All demands met by the Federal Government have costs, and frequently the immediate financial cost is only a small part of the picture. The fabric of our economic system and the future relationships of citizens, businesses, and Government are frequently affected.

Next, the budget reflects a division of responsibility among the Federal and State and local governments. There are some responsibilities, such as national defense and the conduct of international affairs, that are clearly Federal. In many other areas where a national interest is thought to exist, the Federal Government has provided financial assistance to State and local governments, notably in the form of grants-in-aid. Over the past quarter century, the number and variety of grant-in-aid programs has increased manyfold, with a corre-

sponding increase in Federal expenditures and in the amount of taxes levied at the national level. At the same time, State and local taxes have also risen, and there has been a pyramiding of public expenditures.

On numerous occasions, the President has warned against the dangers of overcentralizing power and authority in the national Government. He has made clear his deep conviction that to avoid these dangers state and local governments must be strengthened.

Last year, at his suggestion, a working group of State governors and members of the Federal administration was set up to study, and make recommendations on, this problem. This Joint Federal-State Action Committee has reached impressive agreement on steps to roll back the trend toward central concentration by proposing specific actions to strengthen our traditional system of federalism.

Some of these actions will require both congressional and State legislation. On May 14, in a letter to Speaker Rayburn, the President endorsed the necessary Federal legislation, including the relinquishment of a substantial portion of the local telephone service tax which the Federal Government now collects.

Enactment of this legislation would be an encouraging start in the effort to strengthen State governments. But, in the final analysis, it will be up to all of us to exercise restraint in making new demands on the national government and to work toward strengthening the governments in the communities and states in which we live.

We should never stop trying to assure that the Federal Government's resources are used in the best possible way.

Now, more than ever, with pressures on the Federal budget increasing, we must be sure that we spend where it will do the most good and not just for the sake of spending.

We must also make every effort to insure that fully justified Federal programs are carried out in an efficient manner and on a sound financial basis, so that we get our money's worth for every tax dollar we pay into the Treasury.

We need to do these things to preserve fiscal soundness in government.

Improved Management and Efficiency

With these objectives in mind, a good part of our total effort in the Bureau of the Budget is directed toward better management of Federal programs. We start by examining agency requests for funds when the budget is being prepared, and continue our review of programs throughout the rest of the year.

To take a specific example, we have been pushing vigorously a governmentwide program for the improvement of financial management. It is designed to develop financial information that will better portray the actual costs of agency operations. This should be a great help to individual citizens and taxpayers' organizations, as they weigh the costs of public services against the ends they serve.

In addition, there is now before the Congress legislation that would strengthen controls in the appropriation and use of available funds. This would be accomplished by placing a limitation in each appropriation on the amount of goods and services that could be received under that fund during a given fiscal year. Legislation for this purpose has been strongly supported by the President.

Through improved practices such as these, we shall be able better to control Federal expenditures.

In this connection, however, I'd like to dispel the illusion that the Federal budget can be cut severely simply by squeezing employment costs a little more. That just isn't so. Five years of close attention to this matter have produced large provable savings, but the well has just about dried up. Any future reductions in what we call "bureaucracy" will not save billions, I assure you.

While we will continue to trim our "overhead" costs, the fact to keep in mind is that it is the programs themselves that take the major part of our tax dollars. If we are to affect the amount of Federal expenditures substantially in the long run, we must do it by being more selective in the programs of the Government. We must not only be selective in the new activities we ask the Government to undertake, but we must also be more willing to see reductions in going programs which affect us as well as the other fellow.

The Budget Outlook

I'd like to turn now to the budget outlook as it is currently shaping up.

While we were working on the 1959 budget last fall the Russians successfully launched their first Sputnik, dramatizing technological progress. This has resulted in a substantial step-up in our defense expenditures.

Of course, we too had been making great progress in shifting to modern weapons and reshaping our military strategy over a period of years before the Sputnik. In this connection the 1959 budget reflects two dramatic facts that I would like to mention:

First, more than three-quarters of the total procurement funds in 1959 will go for new types of equipment which hadn't been developed, or weren't being bought in production quantities, as recently as 1955, the first full fiscal year after the Korean conflict.

Secondly, nearly half of the missile program for 1959 will be for the five longer range ballistic missiles—Atlas, Titan, Thor, Jupiter, and Polaris. Only one of these was past the technical study stage 2½ years ago. In 1953, only 1 million dollars was spent on longer range missiles. By last year, 1 billion dollars was spent on them—one thousand times as much. In 1959, we will expand this program still more.

Because of our efforts during recent years, we are adding immeasurably to the power of our forces.

With over half of the budget going for defense, we are determined that this spending shall be devoted to sound and essential purposes and that pressures for pump-priming do not lead to unnecessary military expenditures. But there is no escaping the great cost involved in providing adequately for the security of our country under present world conditions. I'm sure you will agree with me that this is a cost we must meet.

I have already mentioned some important considerations relating primarily to the nondefense portion of the budget. When we prepared the 1959 budget last fall, we took a good look at all of our domestic programs and proposed changes in some of them which would lead to sizeable future savings. These proposals involved reducing programs in which needs were changing, transferring some responsibilities to the States, reducing subsidies, and encouraging private rather than Federal lending. Unfortunately, in the present climate,

they have received very little consideration. This does not mean that we have lost interest or changed our minds about these proposals. We believe that in time they will be fully considered by the Congress.

Let me turn now to what has happened to the nondefense portion of the budget in recent months. The early signs of an economic down turn were just appearing when we prepared the 1959 budget. Since that time various steps have been taken to help reverse it.

The Federal Reserve authorities have eased credit and increased the supply of money. Substantial programs have been enacted, such as the new housing act and legislation to accelerate the highway program. Bills have been passed to extend the present periods of benefits for the unemployed and to enable civilian agencies to speed up planned purchases of supplies and equipment. The executive branch has acted to accelerate defense contracting, promote private housing construction, expedite repair and modernization of Federal buildings, and various other activities. Construction of needed facilities already underway, such as water resource and reclamation projects, is being speeded up in an orderly fashion, and additional 1959 appropriations have been requested for these purposes.

These actions and proposals mean rising expenditures. Therefore, with lower tax collections as well, the deficit in the current fiscal year will be bigger than we anticipated, perhaps over 3 billion dollars. Similarly, a large deficit—in the general magnitude of 8 to 10 billion dollars, according to present tentative estimates—is in prospect for next year instead of the surplus we had planned.

Although deficits are unavoidable now, if the Government is to do its part in promoting economic recovery, we can't close our eyes to what's ahead. Pressures on the Congress are continuing for vast new programs which could commit the Government to large future expenditures. At the present time, with so many programs being proposed as anti-recession measures, we are moving rapidly toward 80-billion-dollar budgets, which could will mean extended deficit spending. This prospect comes just a year after a great deal of indignation was voiced throughout the country about the first peacetime Federal budget totaling 70 billion dollars.

You and I know that in any dynamic situation the factor of change is always to be reckoned with. In private business, the best laid plans are likely to be upset by shifts in consumer preferences, market conditions, and unforseen requirements over and above a normally adequate cushion of reserves.

This is what has now happened to the Federal Budget. Our income is down, our defense costs are up, anti-recession measures are under way, and deficits of serious proportions confront us. Simple prudence compels us to rethink our work programs and look critically at each one of the expenditure proposals being urged upon us. Once turned on, the spigot of Federal expenditures cannot be turned off overnight even though public demand for such action could come about quickly. Equally important, we must guard against the tendency to think that it will not cost anything if the Federal Government does it, and the only way to start the economy upward again is for the Government to go on a spending spree.

A new billion-dollar Federal pro-

gram may sound like a good thing. But it may sound less good when we stop to think about who is going to have to pay for it. Once in our history, and only once, did a single taxpayer report a tax liability of as much as a billion dollars in one year. So let's remember that the next billion-dollar program we consider isn't going to be paid for out of another billion-dollar check from General Motors or some other big corporation. It is we—you and I— and 173 million other Americans who are going to pay, through millions of payroll deductions, and through taxes on cigarettes and automobiles and washing machines and railroad tickets, and with lots of other nickels and dimes and dollars collected on billions of transactions. And even the taxes paid by corporations come from us in the long run, in the prices we pay for the goods and services we buy.

So let's not overemphasize the role of the Government in bringing about economic recovery. And let's remember that if we overdo the expenditure of money by the Government we may find ourselves back fighting inflation again as we were a short time ago.

I have said we must reckon with the factor of change. This does not mean that we either propose to fight change or be overwhelmed by it. Rather, it means that we have to accept it within a perspective that measures its meaning, its needs, and its probable duration. This is far from a "do-nothing" psychology; we are doing plenty, but we should continue doing it with our eyes open—with the proper balancing of our wants and needs against our resources.

Conclusion

So in conclusion, I want to urge that we keep a sense of perspective about our national problems and the budget. The current recession should not cause us to embark on hasty, ill-considered actions which will add unnecessarily to our future burdens.

One of the realities in business is that it can't run continuously at a big deficit. Neither can the Government. If we take our foot off the brake and start rolling with all kinds of spending programs, what we are doing is asking for bigger government and larger budgets.

This could well mean higher taxes instead of the tax relief we all want over the long pull. And the increased taxes cannot all come from the other fellow. It is a foolhardy misconception to think taxes can be paid by something intangible and impersonal called "big business" or "big corporations" without ultimately being borne by all of us as consumers. Our policies should be formulated with the view that a prosperous nation and a prosperous business community go hand in hand.

To foster national prosperity and a better way of life, we must practice financial responsibility. We can begin by holding our Federal budget within reasonable bounds. But this is going to take the understanding and assistance of all segments of our population—individuals, business organizations, and local, State, and national groups. As citizens and as members of this organization, you can, through your cooperation and participation in the making of public policy, contribute a great deal to the present and future strength of America.

The thought I would like to leave with you is that your Government can be no better and no wiser than the measure of your interest, your thinking, and your active responsibility.

THE OPPORTUNITY FOR SERVICE

By Earl Newsom

The phrase, "Opportunity for Service," has a noble ring to it. Indeed, standing alone it may tend to carry the aura of eager do-good-ism. When applied to the profession of accountancy, however, perhaps a different connotation is indicated. Here, I think, the first question anyone is entitled to ask is "The opportunity for service to what?"—and I suppose the answer, stated in its simplest terms, is "Service to society of our time."

Now the surest way for certified public accountants to serve society of their time is to perform as efficiently and effectively and honorably as they can those services their clients pay them to perform.

After all, we are only a few among hundreds of millions who go about our daily chores, each in his own way. We cannot know the total significance of what we do nor assume responsibility for the picture as a whole. We can only do our best as we see it. As Justice Holmes reminds us, "The universe has in it more than we understand," and "The private soldiers have not been told the plan of campaign, or even that there is one."[1]

But when the planners of our meeting here today linked the word "opportunity" to the phrase "for service," I am sure they meant that we should discuss areas quite beyond this basic personal duty. They intended to remind us, I think, that as professional men we have a duty to perform chores for the public good that we are not paid to perform. For this is the tithe we all pay for the privilege of freedom.

There is nothing new to you in this sense of public duty. It has always been an American characteristic—one which provides the very muscles and sinews of our democracy. We insist on voluntarily organizing to solve the problems of our society as the march of progress throws them into our laps. We do not like to leave such matters to the government. We like even less to leave them to self-appointed deliverers. In these things we insist upon taking the initiative ourselves.

Nearly a hundred and twenty years ago, a famous foreign visitor to our shores—the astute political observer, Alexis de Tocqueville—marveled at this odd American characteristic.

"Americans of all ages, all conditions and all dispositions constantly form associations," he wrote. "They have not only commercial and manufacturing companies, in which all take part, but associations of a thou-

[1] Oliver Wendell Holmes, Jr., "Natural Law," 32 Harvard Law Review (1918), 40.

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sand other kinds—religious, moral, serious, futile, extensive or restrictive, enormous or diminutive. The Americans make associations to give entertainments, to found establishments for education, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; and in this manner they found hospitals, prisons, and schools. If it is proposed to advance some truth, or to foster some feeling by the encouragement of a great example, they form a society. Wherever, at the head of some new undertaking, you see the Government in France, or a man of rank in England, in the United States you will be sure to find an association. . .'"[2]

Now, as I have suggested, this sense of public duty has particular significance for professional men. For it is the men of the professions who have traditionally taken leadership in these matters. Public Duty has always been a hallmark of the professions in the civilized world. And in putting this subject on our agenda here in New Orleans, the planners of our meeting may be reminding us that certified public accountancy does not become a profession merely by our dubbing it so; that, in the long run, acceptance and respect by the public will depend upon the growth of a tradition that certified public accountants make the health of a free society a primary consideration in their practice; that without this hallmark, they may tend to be looked upon as any other men of business.

If, then, we accept the idea that certified public accountants ought to take leadership in public chores for the good of society of their time, perhaps we would do well at the outset to take a look at the dynamic society in which we live today. For this is not a static world. It is subject to constant change, and I should like to note in general terms three categories of change in this world on which we propose to leave our mark, always for the better, always for the common good. They are:

1. America's changing place in the world
2. America's changing society and
3. America's changing economy.

America's Changing Place in the World

When we think of America, we tend to dwell on the concept of independence that has sparked our life as a nation and still dominates our character as a people. But the world of our time has become smaller. We cannot hope any longer to work out our own destiny alone. Independence has come to rely on interdependence.

This awareness is apparent in the national budget. For 17 years, nearly two-thirds of our federal expenditures have gone toward arming ourselves and our friends abroad.[3] Since World War II alone, to strengthen our friends overseas, economically and militarily, we have spent some $50 billion and advanced in government credit another $11 billion.[4]

And that represents only our *public* stake in our awakening to the fact of interdependence. Meanwhile, private American capital has flowed outward across the world an at unprecedented pace. Last year alone private long-term investments amounted to over $3.6 billion—twice the sum of our economic aid programs during the

[2] Alexis de Tocqueville, *Democracy in America*, Galaxy Edition, Oxford University Press; 1947, Part II, 319-320.

[3] Table No. 284, p. 238, Statistical Abstract 1957.

[4] Table No. 1117, p. 879, Statistical Abstract 1957.

same period.[5] With private investments abroad now totaling 33 billion,[6] our entire financial stake in interdependence—both public and private—stands at a staggering total of nearly $95 billion.

This has not resulted from a spirit of momentary altruism run wild. It has been dictated by a careful estimate of our enlightened long-term self-interest as a nation, and by realistic considerations of the moment. Private U. S. investments abroad last year *earned* $3.4 billion, and earnings for the first half of this year were at a rate of 5 to 10 per cent above last year.[7]

Furthermore, there has been an even more pressing motive than any desire for current profits. The United States represents only 6 per cent of the world's population, but we are actually consuming half of all the world's production.[8] Every year every person in the United States requires 1,300 pounds of steel, 23 pounds of copper, 798 gallons of oil, and 79 pounds of newsprint.[9] Where our own supplies of vital raw materials and energy fall short, we must depend on overseas sources. And to be sure that we get them, we must invest in the means to produce them. Today enterprising Americans are mining for metals and drilling for oil on every continent of the world.

Foreign *markets* for American goods are also vital to the health and stability of our economy. Of all the tractors made in the United States, for example, 25 per cent are sold abroad. American companies have an almost self-sufficient automotive industry in Brazil, the Japanese drink Pepsi-Cola,[10] and Rumania is an important market for hybrid corn developed in Coon Rapids, Iowa.[11]

The fact is that we have been drawn into the orbit of a rapidly changing world economy. About this we have no more choice than we have about obeying the law of gravity.

Now these new conditions throw out new problems that tend to create road-blocks to further progress, and dealing with many of them falls within the special competence of the profession of accountancy. Indeed, if they were to be ignored by the profession, some other profession would inevitably rise to the occasion and solve the problems—not because anyone wants to poach upon your field, but because, in the end, the job will be done.

In this international area, *The Economist* of London has observed that "The accountant must always be allowed some scope to express his own ideas and fancies,"—that he "should be prepared to be an educator as well as a custodian."[12]

Our investments abroad have already far outgrown the diverse and sometimes archaic accounting procedures of foreign enterprises. The President of the New York Stock Exchange has emphasized that the greatest single barrier to a freer flow of private capital abroad is the lack of full and detailed financial disclosure by companies abroad.[13] The fact is that accounting inadequacies bar all but a relatively few such companies from representation on our own exchanges.

[5] First National City Bank Monthly Letter, Sept. 1957.
[6] Survey of Current Business, U. S. Dept. of Commerce, Aug. 1957.
[7] U. S. Department of Commerce release, Aug. 27, 1957.
[8] The Next Hundred Years, Harrison Brown, James Bonner and John Weir; The Viking Press; 1957, p. 10.
[9] Ibid. pp. 12-13, 18.
[10] Journal of Commerce, May 28, 1957.
[11] New York Times, Sept. 26, 1957.
[12] "Design for Accounting," *The Economist*, Dec. 24, 1955.
[13] "A New Horizon for U. S. Capitalism," Keith Funston before The World Affairs Council in Philadelphia, Jan 13, 1956.

Fortune has called attention to the pressing need to remove this roadblock and to remove it soon.[14]

I am told that today even the terms of accountancy do not have the same meaning in all countries. And yet accountancy has often been defined as the language of business. Perhaps the time has now come when it must be made a truly international language.

Would it not be a useful and constructive step for the profession in America to take the initiative in creating a uniform terminology? Allowing for the diversity of legal and tax conditions under which business is done overseas, should the profession here not begin to elevate the standards of disclosure everywhere? Ought we not to know more than we do about the real effect of inadequate financial reporting on foreign investments? And is the concept of the independent audit one that can be advanced abroad through the profession's working with the overseas lending and development agencies of our federal government?

During the past year the American Institute of Certified Public Accountants has made progress in defining some areas of these problems and in studying approaches to their resolution.[15] But it may not be enough to leave them to a single committee—or even to formal approach by the Institute alone. Certainly, if it is opportunities for service we seek, individual members of the profession personally cannot well overlook the creative opportunities in this new and still strange climate, where venturesome American business and modern American society are acting in the belief that our prosperity, like our independence, is inextricably bound up with the economic growth of the rest of the world.

[14] *Fortune*, March 1956, pp. 72-73.

[15] Minutes, Foreign Affairs Committee, AICPA, June 27, 1957.

America's Changing Society

What is happening within our own American society here at home—and happening with incredible speed—is fully as challenging as changes in the world outside our borders.

We are witnessing today a revolution in American life so sweeping and so cross-hatched with complexities that we cannot yet grasp its significance. Between the turn of the century and 1950, the population of the United States doubled, and now within the last seven years it has grown 13¼ per cent.[16] The most conservative estimates assume a U. S. population of 200,000,000 within the next 12 years.[17]

Moreover, profound changes have occurred in the traditional patterns of our population. The death rate has been halved since 1900. The median age has risen, since mid-19th century, from under 19 years to over thirty.[18] In fifty years the life expectancy of Americans has risen from 47 to over 69½ years—an unbelievable extension of the average life span by over twenty-two years.[19] This has left us with a whole new population to consider in our economy — the people of mature years who have reached a period of relative freedom from the pressures of earlier life.

One of the most striking changes is the spectacular rise in primary families—the key to our domestic economy. These include the homes with growing children that buy the most

[16] Tables No. 1 and 2, p. 5, *Statistical Abstract*, 1957.

[17] Op. Cit. Table No. 3, p. 6.

[18] America's Needs and Resources, J. Frederic Dewhurst & Associates, The Twentieth Century Fund; 1955, pp. 60, 63.

[19] Table No. 64, p. 60, *Statistical Abstract*, 1957.

food, the most appliances, the most clothes, the most automobiles. In 1940, there were in America less than 32,000,000 primary families; by 1950, there were nearly 39,000,000. It is estimated that by 1960 this total will have jumped to 44,000,000.[20]

Simultaneously with these revolutionary advances in the size and components of our population, there has been a remarkable rise in personal income. Within 26 years real per capita income has increased more than 78 per cent.[21] This is after all adjustments for inflation and cost of living. Moreover, this rise has been accompanied by a decline in the average work week of nearly 13½ per cent.[22]

These are exciting and dramatic figures. But they also suggest problems of the most sweeping proportions.

For example, the demands upon our hospitals and recreational facilities have already become severely acute. Our schools and colleges are bursting at the seams—and colleges have not yet come close to the 6,000,000 enrollments inevitable by 1970.[23] We are now facing a desperate shortage of teachers, and those we have are greatly underpaid. Furthermore, the pressing need for renewal and expansion of education plant will require billions of dollars.[24]

I know of the work of the Institute's College Accounting Committee and of the beginning made this year by the new Committee on Accounting for the Public Schools. Access to education is basic to the health of a free and progressive society. And perhaps this is an area which should challenge the instinct for public service in every CPA in every community, every county and every state.

For the area for constructive service here is enormous. Many of the best minds in the country, for example, are devoted to unprecedented efforts to raise funds for privately supported colleges and universities. But what about the best use of existing funds? Cannot your profession help, in cases of your own selection, to bring about improvements in budgeting, allocations and facilities, eliminating duplications and wastages? Education in America, from primary school to university, unable to afford techniques and staff assistance for modern cost analysis and projection, has had to move from crisis to crisis. Is it possible that your discipline can help to make some of these crises less inevitable?

The accounting profession has much in talent and discipline that it can bring to the aid of society in such current tasks. It is in such areas of voluntary leadership reaching down to every community in the land that the real test of a profession comes.

America's Changing Economy

Completely aside from these needs for expanding our social institutions, the basic shifts in American life have been accompanied by subtle and far-reaching changes in our whole industrial economy. Mark Eaton observed recently that "It is doubtful whether anyone now alive thoroughly understands just what is happening to our economic system and what its future shape will be."[25]

Nevertheless, there are certain vis-

20 Op. Cit., Dewhurst and Associates, p. 1118.

21 "Relative National Accounts," National Industrial Conference Board, p. 30.

22 Op. Cit., Dewhurst and Associates, p. 1073, and Statistical Abstract, 1957, pp. 223-225.

23 Report of the President's Committee on Education Beyond the High School, Aug. 10, 1957.

24 Ibid.

25 "Financial Reporting in a Changing Society," an address before the Illinois Society of Certified Public Accountants by Marquis G. Eaton, June 7, 1957.

ible elements in this new economy that we can recognize and that we would do well to start relating to each other and to the total society.

One of these is bigness. We are very far from even an adequate definition of bigness in modern terms, and of its significance to the health and growth of the economy. It is a term no longer relative only to the total industrial output. It has become a characteristic of what it takes to produce the output. For example, the capital investment required for a single body-stamping machine in the automobile business can exceed the total capitalization necessary for highly successful manufacturing ventures in other fields.

Moreover, the real ownership of modern bigness is far more diffuse than ever before in our history. Stockholders, once concentrated in a few financial communities, now number around 10 million, and two-thirds of them earn under $7,500 a year.[26] Many millions more share in the rewards and risks of corporate enterprise through financial institutions, including mutual funds, insurance, and growing pension funds. Through the regulatory agencies of the federal government, all of us have a less direct voice in the control of big industries. Finally, there is the ultimate control of the working economic machine by the consumers, suppliers and employees, the reconciliation of whose interests with those of the stockholders is the real function of modern management.

Meanwhile, our total economy has crashed a new barrier. In the middle of 1956, a little-noted statistical event took place in this country that can have ultimate effects as widespread as those of the industrial revolution itself. For the first time in world economic history, the number of people employed in service occupations (including government, trade, finance, utilities and transportation) exceeded those employed in the production of goods.[27]

Consider for a minute merely the surface significance of this. We are producing more with proportionately less people, and it is likely that increased automation will reduce production employees even more. This may mean that the controlling element in the economics of manufacturing will gradually shift from labor costs to technological research and capital equipment. It means that more and more people—as the majority now are—will be concerned with servicing others—in the professions, in distribution and selling, in finance, in utilities, transportation, communications. It may mean less vulnerability to the old cyclical patterns of depressions. It means more leisure and more real wealth for more people.

Now how well do any of us, in management or among those who serve management, really understand all this? How clear a sense do we have of where we are going or of what the pitfalls may be?

Now this seems to me to represent an opportunity of historic proportions for all the professions that serve management. It is our duty—in fact our greatest present claim to usefulness—to examine the premises and to help construct the new principles that reflect things as they are in practice. Only by understanding, ourselves, what is really happening can we hope to guide and make the most of this economic revolution.

In the long run, if we do not understand things as they are, we have

[26] "Who Owns American Business," 1956 Census of Stockholders, N. Y. Stock Exchange.

[27] "An American Revolution," editorial in the *New York Times*, April 1, 1957.

little chance of shaping things as they might be. I do not believe that since America passed from an agrarian to an industrial economy, with the disruptions and trials and errors of a century in its wake, there has been a greater and more pivotal opportunity than this challenge to understand, to explain, and to help chart our new economy.

Is it not reasonable to assume that in this vital area so close to our own door-step there are opportunities for creative contribution by the discipline of accountancy?

And now, in initiating today's discussion, I have thrown out far too much, far too glibly. If I have been wrong in emphasis, I hope it has been by way of overstatement rather than understatement.

All that I have said is intended as elaboration on one central theme. That theme is that a profession, like all human effort, grows as it rises to the challenge of its environment. The direction of our duty and our opportunity is not clear, but somewhere in this maze of things as they seem to be, professional duty surely calls.

In the beginning of my remarks, I cited the late Justice Holmes. In closing, let me quote from the passage in his essay on "Natural Law," to which I referred:

> "That the universe has in it more than we understand, that the private soldiers have not been told the plan of campaign, or even that there is one. . . has no bearing upon our conduct. We still shall fight—all of us because we want to live, some, at least, because we want to realize our spontaneity and prove our powers, for the joy of it. . . If our imagination is strong enough to accept the vision of ourselves as parts inseverable from the rest, and to extend our final interest beyond the boundary of our skins, it justifies the sacrifice even of our lives for ends outside of ourselves. The motive, to be sure, is the common wants and ideals that we find in man. Philosophy does not furnish motives, but it shows men that they are not fools for doing what they already want to do. It opens to the forlorn hopes on which we throw ourselves away, the vista of the farthest stretch of human thought, the chords of a harmony that breathes from the unknown."[28]

[28] Op. Cit.

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